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VIA ELECTRONIC SUBMISSION

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

Re: Proposed Rule, *Position Limits for Derivatives*, RIN 3038-AD99

Dear Secretary Kirkpatrick:

I. INTRODUCTION.

On behalf of The Commercial Energy Working Group (the "**Working Group**"), Eversheds Sutherland (US) LLP hereby submits this letter in response to the request for public comment set forth in the Commodity Futures Trading Commission's (the "**CFTC**" or "**Commission**") Proposed Rule, *Position Limits for Derivatives* (the "**Proposed Rule**") published in the *Federal Register* on February 27, 2020,[1] which proposes to establish federal speculative position limits for certain commodity derivatives pursuant to Commodity Exchange Act ("**CEA**") Section 4a(a),[2] as amended by Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**").[3]

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial, and residential consumers. Members of the Working Group are producers, processors, merchandisers, and owners of energy commodities. Among the members of the Working Group are some of the largest users of energy derivatives in the United States and globally. The Working Group considers and responds to requests for comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

[1] Proposed Rule, *Position Limits for Derivatives*, 85 Fed. Reg. 11,596 (Feb. 27, 2020).

[2] 7 U.S.C. § 6a(a).

[3] H.R. 4173, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

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Since the initial proposed rulemaking on federal speculative position limits for derivatives was issued by the Commission under the Dodd-Frank Act in March 2011, the Working Group has actively engaged with the staff in the Chairman and Commissioners' offices, staff in the Division of Market Oversight ("**DMO**"), and various industry groups to develop an appropriately-tailored regulatory framework that meets the Commission's statutory obligations under CEA Section 4a(a) to prevent excessive speculation in commodity derivatives markets while avoiding harm to legitimate commercial hedging activities.[4] The Working Group appreciates the continued efforts and dedication of the Commission and DMO staff and their willingness to maintain a constructive dialogue throughout this nine-year rulemaking process.

Recent external events of an unprecedented scale show how effective hedging strategies are necessary for commercial businesses to withstand market events. Notwithstanding relatively stable energy prices and a strong, growing economy, these events have injected substantial volatility in global markets for energy commodities. Unfortunately, these events are also creating significant economic disruption and uncertainty for a large number of Americans – both at the corporate and consumer levels – and are forcing many commercial firms to reconsider how they will continue to economically meet their obligations to deliver physical energy products to others while managing unforeseen and dynamic shifts in their exposure to price risk.

The unsettling global and economic circumstances reaffirm the need for a workable regulatory framework that includes a coherent and coordinated approach to commercial hedging that (i) draws upon the experience, expertise, and resources of designated contract markets ("**DCMs**") and swap execution facilities ("**SEFs**") (collectively, the "**Exchanges**"), and (ii) provides commercial firms with discretion and flexibility to identify and, as necessary, reevaluate their exposures to physical commodity price risk and adjust their hedging strategies as they deem appropriate in their business judgment to efficiently and effectively mitigate these risks. At this moment of crisis, it is imperative that the Commission ***avoid*** the adoption of a regulatory framework for federal speculative position limits that incorporates a rigid "one-size-fits-all" approach to commodity risk management that substitutes pre-determined Commission

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[4] *See* The Commercial Energy Working Group & Commodity Markets Council, *Joint Comment Letter Re: Reproposal, Position Limits for Derivatives*, RIN 3038-AD99 (Feb. 28, 2017) ("**February 2017 Letter**"); The Commercial Energy Working Group, *Comment Letter Re: Supplemental Notice of Proposed Rulemaking, Position Limits for Derivatives: Certain Exemptions and Guidance,* RIN 3038-AD99 (July 13, 2016) ("**July 2016 Letter**"); The Commercial Energy Working Group, *Comment Letter Re: Position Limits for Derivatives*, RIN 3038-AD99 (Mar. 30, 2015) ("**March 2015 Letter**"); The Commercial Energy Working Group, *Comment Letter Re: Position Limits for Derivatives*, RIN 3038-AD99 (Aug. 4, 2014) ("**August 2014 Letter**"); The Commercial Energy Working Group, *Comment Letter Re: Position Limits for Derivatives*, RIN 3038-AD99 (Feb. 10, 2014) ("**February 2014 Letter**"); Working Group of Commercial Energy Firms, Comment Letter, Position Limits for Derivatives, RIN 3038-AD15 and 3038-AD16 (Mar. 28, 2011) ("**March 2011 Letter**) (collectively, the "**Comment Letters**") (In February 2012, the Working Group of Commercial Energy Firms reconstituted itself as "The Commercial Energy Working Group"). The Working Group has also submitted the following public filings to the Commission related to these proceedings addressing the implementation of federal speculative positions limits. *See* The Commercial Energy Working Group, *Request for Exemptive Relief No. 7 for Working Session on BFH Petition* (submitted to S. Sherrod, Senior Economist, Division of Market Oversight, on Sept. 19, 2012); Working Group of Commercial Energy Firms, *Petition for Commission Order Granting Exemptive Relief for Certain Bona Fide Hedging Transactions under Section 4a(a)(7) of the Commodity Exchange Act* (Jan. 20, 2012) ("**BFH Petition**"), http://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/wgbfhpetition012012.pdf; *see also* The Commercial Energy Working Group presentations and comments provided at the CFTC's July 29, 2015 Energy and Environmental Markets Advisory Committee ("**EEMAC**") Meeting, https://www.youtube.com/watch?v=xpE-sthXOws&feature=youtu.be; February 26, 2015 EEMAC Meeting ("**2015 EEMAC Meeting**"), https://www.youtube.com/watch?v=yGLWQsuqZ-w&feature=youtu.be; and June 19, 2014 Position Limits Roundtable ("**2014 Roundtable**"), https://www.youtube.com/watch?v=jx5ZryxlRsI&feature=youtu.be; https://www.youtube.com/watch?v=pbKC8GJeQGU&feature=youtu.be.

limitations for the discretion and business judgment of commercial firms. The Proposed Rule accomplishes this objective.

The Working Group requests that the Commission consider the comments provided herein and urges the Commission to continue its dialogue with market participants and, importantly, the Exchanges, so that it may bring this rulemaking proceeding to an ultimate conclusion through the issuance of a final rule later this year. The federal position limits rule is a unique opportunity for the Commission to adopt a regulatory framework that will bring certainty in uncertain times and for the longer-term horizon.

II. COMMENTS OF THE COMMERCIAL ENERGY WORKING GROUP.

A. The Working Group Generally Supports the Adoption of the Regulatory Framework for Federal Speculative Position Limits Set forth in the Proposed Rule.

1. The Proposed Rule Strikes an Appropriate Balance Between Preventing Excessive Speculation and Permitting Legitimate Commercial Hedging Activity.

The Proposed Rule takes a substantial step forward, both structurally and substantively, over the Commission's prior rulemaking proposals to ensure the Commission meets its statutory obligations under CEA Section 4a(a) to reduce or prevent excessive speculation and, at the same time, allowing commercial firms to effectively manage their exposure to price risk.[5] These obligations are protected through an array of safeguards, including the enforcement of Commission rules and regulations, requirements placed on the Exchanges by the Proposed Rule, the Exchanges' own self-interests and extensive expertise in operating fair, orderly, and efficient markets, and effective Commission oversight.

The Working Group supports the following features in the Proposed Rule as examples of the Commission crafting fair and balanced position limits regulations:

- Delegating authority to the Exchanges to implement and administer many important and nuanced aspects of the new federal regime for speculative position limits, including the administration of exemptions for certain "bona fide hedging transactions or positions" ("**BFH**") therefrom, subject to Commission oversight;

- Limiting the federal regime to spot month speculative limits in markets for energy commodity derivatives;

- Permitting Exchanges to impose accountability levels for non-spot months in energy markets;

- Recognizing more appropriate, updated deliverable supply estimates for purposes of establishing federal speculative position limits;

- Developing a generally workable definition of "economically equivalent swap";

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[5] *See* Reproposal, *Position Limits for Derivatives*, 81 Fed. Reg. 96,704 (Dec. 30, 2016) ("**December 2016 Proposal**"); Supplemental Notice of Proposed Rulemaking, *Position Limits for Derivative: Certain Exemptions and Guidance*, 81 Fed. Reg. 38,458 (June 13, 2016) ("**July 2016 Proposal**"); Notice of Proposed Rulemaking, *Position Limits for Derivatives*, 78 Fed. Reg. 75,680 (Dec. 12, 2013) ("**December 2013 Proposal**") (collectively, the "**Prior Releases**"). The Commission issued the Proposed Rule as a new proposal and, in doing so, has expressly withdrawn the Prior Releases from further consideration. Proposed Rule at 11,597.

- Expressly withdrawing the novel, overly narrow, and restrictive interpretation of the BFH definition proposed in the Prior Releases;

- Adopting a commercially-practicable interpretation of the definition of BFH and issuing new guidance on the use of gross hedging that will allow hedgers to continue to use their discretion and business judgment to effectively identify and manage their exposures to price risk in physical commodity markets;

- Adopting an expanded list of enumerated hedge exemptions (each, an "**Enumerated BFH**"), including anticipated merchandising, and permitting a number of the proposed Enumerated BFHs to be utilized on a cross-commodity basis;

- Including a dual track process for commercial firms to pursue BFH exemptions that do not fall within any of the Enumerated BFHs set forth in the Proposed Rule (each, a "**Non-Enumerated BFH**") that permits commercial firms to apply for such exemptions (i) directly to the Commission or (ii) using a streamlined process administered by the Exchanges;

- Eliminating from federal position limits the prohibition on the ability to hold a physically-settled Referenced Contract as BFH during the last five days of trading (or during the time period for the spot month if less than five days) ("**Five Day Rule**");

- Including a BFH exemption for offsets of pass-through swap positions that qualify for treatment as BFHs;

- Including an exemption from applicable federal speculative position limits for certain enumerated spread transactions and for persons under financial distress;

- Excluding trade options from the Referenced Contract definition and providing BFH treatment for Referenced Contracts that hedge trade options;

- Striking regulations like CFTC Regulation 1.48 that required administrative process before a commercial firm might use certain anticipatory BFHs; and

- Eliminating monthly reporting of cash-market positions under Form 204 and the Series '04 Form reporting requirements applicable to BFH activity proposed in the Prior Releases.

2. <u>The Exchanges Are Best Positioned to Administer Significant Portions of the Proposed Regulatory Framework for Federal Speculative Position Limits</u>.

Given their intimate knowledge of physical commodity markets and the commercial practices of participants in such markets, the Exchanges possess the expertise, experience, and resources to effectively administer substantial aspects of the framework for federal speculative position limits delegated to them in the Proposed Rule. Importantly, they possess the regulatory infrastructure to ensure that the process for approving certain BFH exemptions from applicable federal position limits meets the requirements of CEA Section 4a(a)(3)(B).

Pursuant to Exchange rules, and as recognized in the Proposed Rule, before a BFH exemption from exchange-set speculative position limits is granted, a market participant must, among other things, (i) provide a complete and accurate description of the underlying exposure relating to an exemption request, (ii) agree to provide further information upon request from the Exchange, (iii) agree to liquidate positions in an orderly manner when so ordered by the Exchange, and (iv) represent compliance with all other Exchange rules.[6]

After a BFH exemption is granted, the Exchanges actively monitor participants' positions. To perform this function, among other things, the Exchanges (i) employ well-trained market surveillance teams that are experts in current market conditions, (ii) communicate regularly with market participants to understand their trading strategies and intentions, and (iii) where appropriate, request and receive detailed information from market participants.[7] If an Exchange has concerns with the size of a market participant's position under an exemption from speculative position limits, it has, and has demonstrably used, its authority under Commission-approved market rules to "jawbone" or order the market participant to reduce such position and ensure that such position does not create a threat to orderly markets.[8] The Exchanges also may require a market participant to reduce its positions by modifying or revoking an exemption.[9] This regime has been in place and has worked effectively since 1981.[10]

Further, the Commission may also rely on the Exchanges to administer and manage the proposed federal regime properly as they carry out their regulatory duties under applicable DCM and SEF Core Principles.[11] Specifically, DCM Core Principle 4 and SEF Core Principles 4 and 5 obligate the Exchanges to monitor trading as well as surveil their markets for anomalies to prevent manipulation, price distortion, disruptions of the delivery or cash-market settlement process, and position limits violations. In addition, DCM Core Principle 5 and SEF Core Principle 6 require the Exchanges to implement and enforce speculative position limits and accountability levels to reduce the threat of market manipulation or congestion (especially in the delivery month).

The collective obligations imposed on the Exchanges under these Core Principles will ensure the proposed federal regime is effectively managed to preserve orderly markets. In addition to the Core Principles, the Exchanges have self-interest in protecting market participants from the harm speculative position limits are intended to prevent, such as ensuring that (i) the price of the spot futures contract converges with the cash price, and (ii) a market participant with an exemption does not trade in a manner that causes adverse price impacts to the market.

Finally, the Commission will retain full oversight of the Exchanges' administration of the proposed federal regime through its rule enforcement review process. Through its rule enforcement review process, the Commission oversees the Exchanges' compliance with their Core Principles, including the implementation and enforcement of speculative position limits

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[6] *See, e.g.,* New York Mercantile Exchange ("**NYMEX**") Rule 550; ICFE Futures U.S. ("**IFUS**") Rule 6.29; Nodal Exchange Rule 6.5; NASDAQ Futures Rules Chapter V, Section 13(d). *See* Proposed Rule at 11,642-43.

[7] *See, e.g.,* NYMEX Rules 559 and 560; IFUS Rules 6.13 and 6.29(b). The market surveillance function of the Exchanges monitor positions and trading on an intraday basis and often communicate with market participants to discuss trades and positions on a real-time basis to protect market integrity and ensure fair and orderly trading.

[8] *See, e.g.*, NYMEX Rule 560.

[9] *See, e.g.,* NYMEX Rule 559; IFUS Rule 6.29(b).

[10] *See* Final Rule, *Establishment of Speculative Position Limits*, 46 Fed. Reg. 50,938 (Oct. 16, 1981).

[11] *See* CFTC Regulations 37.400-08 (SEF Core Principle 4); 37.500-04 (SEF Core Principle 5); 37.600-01 (SEF Core Principle 6); 38.250-58 (DCM Core Principle 4); 38.300-01 (DCM Core Principle 5).

under SEF Core Principle 6 and DCM Core Principle 5. The CFTC has conducted several rule enforcement reviews covering DCM Core Principle 5 and exemptions from speculative position limits[12] and is expected to perform similar reviews of SEFs in the future. Although the Commission identified deficiencies or made limited recommendations for improvement, the Working Group did not find a single instance where a rule enforcement review attributed excessive speculation or disorderly markets to the abuse of an Exchange-granted hedge exemption.[13] Importantly, the Proposed Rule does not in any way diminish the Commission's ability to oversee through its rule enforcement review process the exemption process and, in fact, enhances the Commission's ability to effectively oversee commodity derivatives markets through the use of the Exchanges who are best positioned to administer the proposed federal regime.

3. The Commission Should Conclude the Rulemaking for Federal Speculative Position Limits and Issue a Final Rule as Soon as Possible.

The Working Group commends the Commission for pressing ahead with the rulemaking for federal position limits and recommends that the Commission, building upon the solid foundation of the Proposed Rule, issue a final rule as soon as possible. These are difficult times and the commodity market participants are seeing dramatic price moves. These times require firms to engage in active hedging practices to address risk in their commercial enterprises. The CFTC would help commodity markets remain robust by introducing the certainty of a final rule regarding federal position limits. As mentioned above, the Commission has been actively working on this rulemaking for many years. The Proposed Rule represents a solid foundation for the federal position limits regime. Thus, the Commission would serve the markets well by issuing a final rule regarding federal position limits.

B. Recommendations to Ensure That the Commission Finalizes a Speculative Position Limits Rule That Does Not Impede Upon the Ability of Commercial Firms to Effectively Manage Risk.

The overriding principle in allowing commercial market participants the opportunity to hedge their risks with derivatives is that, by reducing risks in the supply chain, the costs of commodities to consumers ultimately will be kept low. Chairman Tarbert and other Commissioners have asserted that, before a speculative position limit rule should be finalized, care must be taken to ensure that the rule does not restrict the ability of commercial market participants to manage risk.[14] The recommendations provided herein by the Working Group are limited and specific with goal of accomplishing that objective. The Working Group's recommendations are consistent with the statutory requirements under the CEA and Commission intent underlying the issuance of the Proposed Rule and do not present any additional risk of excessive speculation.[15]

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[12] Examples of the more recent rule enforcement reviews addressing this core principles include: (i) NYMEX and COMEX (Oct. 11, 2016); (ii) the Minneapolis Grain Exchange, Inc. (June 5, 2015); (iii) IFUS (July 22, 2014); and (iv) the Chicago Mercantile Exchange and Chicago Board of Trade (July 26, 2013).

[13] *See* https://cftc.gov/IndustryOversight/TradingOrganizations/DCMs/dcmruleenf.html.

[14] *See Opening Statement of Chairman Heath P. Tarbert Before the Energy and Environmental Markets Advisory Committee* (May 7, 2020), https://cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement050720; *Opening Statement of Commissioner Brian Quintenz Before the Energy and Environmental Markets Advisory Committee* (May 7, 2020), https://cftc.gov/PressRoom/SpeechesTestimony/quintenzstatement050720.

[15] *See, e.g.,* Proposed Rule at 11,731, Appendix 2 – Supporting Statement of Chairman Heath Tarbert; Proposed Rule at 11,733, Appendix 3 – Supporting Statement of Commissioner Brian Quintenz; Proposed Rule at 11,739-40, Appendix 5 – Supporting Statement of Commission Dawn Stump.

1. Bona Fide Hedging.

As noted in Section I, above, the Working Group generally supports the Commission's clarified approach to BFH activities discussed in the Proposed Rule.[16] The Working Group appreciates that the Proposed Rule does not adopt a rigid "one-size-fits-all" approach to commodity risk management that substitutes pre-determined Commission limitations for discretion of market participants to identify their exposures to commodity price risk, value those risks, and mitigate them as deemed appropriate in the exercise of their business judgment.[17]

The Proposed Rule appropriately recognizes that hedging price risk exposures associated with complicated physical energy portfolios can be a nuanced and complex process.[18] Location, product, and timing characteristics, each individually and in combination, all uniquely factor into the evaluation of risk. Moreover, market participants have different corporate structures, hedging objectives, and each subjectively evaluate risks differently. By providing market participants with flexibility to manage their exposures in accordance with their business objectives, whether at the level of aggregated affiliates, legal entity, desk, book, asset, or at any other level, the Proposed Rule will facilitate efficient hedging in physical commodity markets which, in turn, will help to reduce costs of commodities delivered to others, including consumers.

a. The Commission Should Expressly Clarify That Gross Hedging Is Permitted Regardless of Whether a Market Participant Is Utilizing an Enumerated BFH or Non-Enumerated BFH.

The Working Group supports the inclusion of new proposed guidance on the use of gross hedging practices set forth in Appendix B, paragraph (a). The Proposed Rule appropriately recognizes that gross hedges warrant BFH treatment in circumstances where net cash positions do not necessarily measure total risk exposure due to differences in the timing of cash commitments, the location of stocks, and differences in grades or types of cash commodity. It also recognizes that large complex entities may have hedging needs that are not met solely through the use of gross or net hedging.[19] For the reasons noted below, the Working Group requests that the Commission make an important clarification and corresponding revision to the gross hedging guidance set forth in Appendix B, paragraph (a)(1) that expressly acknowledges that market participants may engage in gross hedging when utilizing either Enumerated BFHs or Non-Enumerated BFHs from applicable federal speculative position limits.

Specifically, the language discussing gross hedging in the preamble text of the Proposed Rule and in paragraph (a) of the Appendix B guidance could be interpreted as limiting the use of gross hedging to Non-Enumerated BFHs by reference to proposed Regulation 150.9, which is the provision for the streamlined approach for seeking a Non-Enumerated BFH managed by the Exchanges. In relevant part, the preamble text discussing gross hedging states as follows:

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16 Proposed Rule at 11,613-614; Proposed Paragraph (a) of Appendix B to Part 150.

17 *See* February 2014 Letter at 11-14; July 2016 Letter at 15-17; February 2017 Letter at 10-15.

18 Proposed Rule at 11,613.

19 Proposed Rule at 11,613.

> The Commission continues to believe that a gross hedge may be a bona fide hedge in circumstances where net cash positions do not necessarily measure total risk exposure due to differences in the timing of cash commitments, the location of stocks, and differences in grades or types of cash commodity. However, the Commission clarifies that these may not be the only circumstances in which gross hedging may be recognized as bona fide. Like the analysis of whether a particular position satisfies the proposed bona fide hedge definition, *the analysis of gross hedging may be utilized would involve a case-by case determination by the Commission and/or by an exchange using its expertise and knowledge of its participants as it considers applications under § 150.9, subject to Commission review and oversight*.
>
> (Emphasis added).[20]

Further, the guidance in Appendix B, paragraph (a)(1) could be viewed as a four-part conjunctive test, and states as follows

> (A) The manner in which the person measures risk is consistent over time with and follows a person's regular historical practice for that person;
>
> (B) The person is not measuring risk on gross basis to evade federal position limits set forth in § 150.2 or the aggregation rules in § 150.4;
>
> (C) The person is able to demonstrate compliance with paragraphs (A) and (B) upon request of the Commission and/or of designated contract market, including by providing information regarding the entities with which the person aggregates positions; *and*
>
> *(D) A designated contract market or swap execution facility that recognizes a particular gross hedging position as bona fide pursuant to § 150.9 documents the justification for doing so, and maintains records of such justifications in accordance with § 150.9(d)*.
>
> (Emphasis added).

The express reference in paragraph (a)(1)(D) of Appendix B to proposed Regulation 150.9 could be read as requiring that a market participant to seek a Non-Enumerated BFH if it intends to use gross hedging practices for BFH positions held above applicable federal speculative position limits. Such a limitation would significantly undercut the utility and benefits provided to commercial hedgers through the proposed adoption of the expanded list of Enumerated BFHs set forth in Appendix A to proposed Part 150 of the CFTC Regulations. Further, it will likely require many commercial energy firms and other commercial hedgers who utilize gross hedging as part of their normal risk management practices in physical commodity markets to seek Non-Enumerated BFHs *for a large number of day-to-day, industry standard hedging activities*. Such a result would be contrary to the Commission's expectations that the Non-Enumerated BFH process would be utilized only in "rare and exceptional" circumstances.[21]

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[20] Proposed Rule at 11,613.

[21] Proposed Rule at 11,650.

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If it is the Commission's intent to provide commercial hedgers with the flexibility to use gross hedging when managing exposures covered by Enumerated BFHs and Non-Enumerated BFHs, any final rule issued in this proceeding should provide such clarification. In furtherance of such clarification, the Working Group proposes the following revision to the gross hedging guidance set forth in Appendix B, paragraph (a)(1):

> (A) The manner in which the person measures risk is consistent over time with and follows a person's regular historical practice for that person;
>
> (B) The person is not measuring risk on gross basis to evade federal position limits set forth in § 150.2 or the aggregation rules in § 150.4; **and**
>
> (C) The person is able to demonstrate compliance with paragraphs (A) and (B) upon request of the Commission and/or of designated contract market, including by providing information regarding the entities with which the person aggregates positions.~~; *and*~~
>
> ~~**(D) A designated contract market or swap execution facility that recognizes a particular gross hedging position as bona fide pursuant to § 150.9 documents the justification for doing so, and maintains records of such justifications in accordance with § 150.9(d)**~~.

The Working Group notes that appropriate safeguards exist to protect against excessive speculation and ensure that the use of gross hedging in the context of Enumerated BFHs from federal position limits is not abused, which include the following:

- The hedge position must fall within the BFH definition in proposed Regulation 150.1 and comply with the requirements of proposed Regulation 150.3(a)(1).
- Prior to utilizing an Enumerated BFH, a market participant will almost certainly obtain a corresponding hedge exemption from applicable exchange-set limits pursuant to proposed Regulation 150.5(a).
- The process of reviewing an application for an exemption from exchange-set limits pursuant to proposed Regulation 150.5(a)(2)(ii) will provide the Exchanges with the opportunity to:
  - Confirm whether a market participant's use of gross hedging is consistent with its historic practices for measuring risk as required by paragraph (a)(1)(A) of Appendix B; and
  - Review the relevant facts and circumstances, including detailed position information, pursuant to which the market participant would use gross hedging practices.
- The Commission will have transparency into such activities through the monthly reporting obligation that would be imposed on the Exchanges to provide summary reports of all BFH exemptions from exchange-set limits that involve commodity derivative contracts that are subject to federal position limits pursuant to proposed Regulation 150.5(a)(4).
- Commercial firms seeking BFH exemptions from exchange-set limits are required to retain records pursuant to CFTC Regulation 1.31.

- The Commission retains additional avenues for reviewing the use of gross hedging by market participants when utilizing Enumerated BFHs through the broad special call authority delegated to DMO and the Division of Enforcement under proposed Regulations 150.3(e) and 19.03, respectively.[22]

b. The Commission Should Permit the Enumerated BFHs for Anticipated Unfilled Requirements and Anticipated Merchandising to Be Used as Cross-Commodity Hedges.

The Working Group appreciates the straightforward approach of including paragraph (a)(5) in Appendix A, which would allow market participants to utilize eight of the eleven Enumerated BFHs set forth in Appendix A as cross-commodity hedges.[23] Given the diversity of grades and specifications and liquidity in energy markets, it is industry-standard practice across all sectors of the energy industry for commercial firms to hedge their exposure to price risk in physical energy markets on a cross-commodity basis. However, without providing any supporting policy basis or rationale, the Proposed Rule omits two industry-standard and highly-utilized hedges in energy markets from the list of hedge exemptions set forth Appendix A, paragraph (a)(5) – Unfilled Anticipated Requirements and Anticipated Merchandising.[24]

The Working Group cannot reconcile this omission with the preliminarily determination in the Proposed Rule that Request No. 10 set forth in the Working Group's BFH Petition, which involves holding a cross-commodity hedge using a physically-settled Referenced Contract to meet unfilled anticipated requirements, would potentially fit in paragraph (a)(5) of the Appendix A, if applicable requirements are met.[25] The Working Group fully supports the Commission's preliminary determination with respect to Request No. 10, and notes that any final rule issued in this proceeding that does not permit the Enumerated BFH for Unfilled Anticipated Requirements or the Enumerated BFH for Anticipated Merchandising to be used as cross-commodity hedges will have a significant, adverse impact on legitimate commercial hedging activities in energy markets.

The following examples illustrate industry-standard and highly-utilized cross-commodity hedges of Unfilled Anticipated Requirements or Anticipated Merchandising by commercial energy firms. As noted below, the decision by commercial energy firms to hedge on a cross-commodity basis is often driven by a number of factors, including but not limited to, the fact the (i) there is no available liquid commodity derivative contract in the same underlying commodity as the cash commodity being hedged, (ii) the fluctuations in prices between the cash commodity being hedged and the commodity derivative contract used as the hedge are substantially related, and (iii) liquidity of the market for the applicable commodity derivative contract.

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[22] These safeguards are collectively referred to herein as the "**Enumerated Safeguards**."

[23] Specifically, pursuant to paragraph (a)(5) in Appendix A of proposed Part 150, a market participant may utilize the following Enumerated BFHs listed in Appendix A on a cross-commodity basis: (i) hedges of unsold anticipated production; (ii) hedges of offsetting unfixed-price cash commodity sales and purchases; (iii) hedges of anticipated mineral royalties; (iv) hedges of anticipated services; (v) hedges of inventory and cash commodity fixed-price purchase contracts; (vi) hedges of cash commodity fixed-price sales contracts; (vii) hedges by agents; and (viii) offsets of commodity trade options.

[24] The Enumerated BFH for Unfilled Anticipated Requirements and Anticipated Merchandising are respectively set forth in Appendix A, paragraphs (a)(10) and (a)(11).

[25] Proposed Rule at 11,611.

Cross-Commodity Hedges of Unfilled Anticipated Requirements

Scenario No. 1 - Crude Oil Feedstock for Refining Operations

*Refiner A is part of the downstream division of a U.S.-based, multinational, integrated energy company. Refiner A's facility is located on the U.S. Gulf Coast ("**USCG**") and can accept waterborne deliveries of crude oil. Given this capability, Refiner A routinely imports cargoes of light sweet crude oil delivered from West Africa and the Middle East as feedstock for this facility.*

*During the early first quarter of 2020, Refiner A enters into negotiations to purchase a delivered cargo of West African ("**WAF**") crude in order to maintain required operational inventory levels at its USGC facility. The pricing dates for the cargo are July 18, 19, and 20, 2020. In anticipation of purchasing the cargo and to protect against upside price risk during the pricing period, Refiner A puts on a long position in the August NYMEX Light Sweet Crude Oil (CL) futures contract as a cross-commodity hedge. There is no commodity derivative contract listed where WAF crude is the underlying commodity and this grade of light sweet crude oil is not deliverable under the NYMEX CL futures contract.*[26]

The spot limit period for August NYMEX CL futures contract overlaps with the pricing dates for the cargo of West African crude. As a consequence, Refiner A will hold its long position in the August NYMEX CL futures contract in the spot month as a BFH of its unfilled anticipated requirements and will ratably lifts this position as the cargo prices in during this period.

Scenario No. 2 - Gasoline Blendstocks and Blending Operations[27]

Company A is a major oil and gas company with gasoline blending operations located at its terminal in New York Harbor. Company A often purchases its anticipated requirements of certain gasoline blendstocks, including Alkylate, Reformate, and Naphtha, from third-party suppliers. Generally, Company A will purchase cargos of these blendstocks that are delivered to its terminal in New York Harbor, blended in tank, and subsequently delivered to its network of retail gasoline stations located throughout Tri-State Area (i.e., New York, Connecticut, and New Jersey).

Recently, Company A entered into a term deal to purchase waterborne cargos of reformate, a high octane gasoline blending component, from a large Asian refiner. In anticipation of this transaction, Company A put on a long position using the NYMEX RBOB Gasoline (RB) futures contract, a physically-settled Referenced Contract, in different months, as a cross-commodity hedge to protect against upside price risk during the pricing dates for the cargos purchased under the term deal. Because there is no recognized liquid commodity derivative contract for reformate, and because the reformate will ultimately be transformed into RBOB gasoline, the NYMEX RB futures contract is viewed as the best available hedge due to (i) its price correlation with

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[26] *See* NYMEX Rule 200.

[27] Request No. 10 of the BFH Petition specifically addressed the circumstances under which a commercial energy firm would hold a physically-settled Referenced Contract as a cross-commodity hedge of its exposure to price risk associated with unfilled anticipated requirements for gasoline blendstocks. In light of Request No. 10 and the example set forth above, the Working Group requests that any final rule issued in this proceeding expressly clarify that gasoline blending operations would qualify as "processing" under the Enumerated BFH for Unfilled Anticipated Requirements.

reformate and (ii) the significant liquidity in the market for the NYMEX RB contract.

If the spot limit period of NYMEX RB futures contracts overlaps with the pricing dates of the cargos of reformate, Company A will ratably sell RB futures to reduce its length in the expiring contract as the cargo of reformate prices in during the spot limit period.

Cross-Commodity Hedges of Anticipated Merchandising Transactions

Scenario No. 1 - Merchandising of Aviation "Jet" Fuel

*A stand-alone affiliate of an integrated energy company engaged in the business of merchandising ("**Energy Marketer**") routinely enters into contractual commitments to purchase and sell aviation fuel (i.e., jet fuel) to third-parties, including major airlines and airports located in and outside of the U.S. Because Energy Marketer is part of an integrated energy company, it has the optionality to source jet fuel supplied to its customers either from affiliated refining operations or from unaffiliated third-party purchases.*

Based on its historic commercial relationships, Energy Marketer anticipates entering into agreements with airports based in the Mid-Atlantic and Northeast regions of the U.S. to supply them with jet fuel. Due to the reduced slate of products currently being refined by its affiliates, Energy Marketer must purchase jet fuel from an unaffiliated third-party European refiner and resell it to the U.S. airports. In order to protect against upside price risk associated with the European jet fuel, the marketer purchases IFEU Gasoil futures corresponding to the month of the physical purchase. Upon taking title to the product, the company sells the IFEU Gasoil futures and also NYMEX NY Harbor ULSD (HO) futures to manage the downside price exposure associated with the cargo of jet fuel that it now owns. The NYMEX NY Harbor ULSD (HO) futures acts as a cross-commodity hedge of the marketer's exposure to potential downside price risk. Due to the absence of any liquid commodity derivative contract where the underlying commodity is jet fuel and the significant price correlation between the NYMEX HO futures contract and jet fuel, the NYMEX HO contract is viewed as the best available hedge.

Due to a delay in transit, the cargo of jet fuel will be delivered and priced out to the airport during the spot limit period of the expiring NYMEX HO futures contract. The Energy Marketer will hold its positions in the NYMEX HO futures contract during the spot month as a BFH of this anticipated merchandising position and ratably lift this BFH position as the cargo of jet fuel prices out.

Scenario No. 2 - Irrevocable Binding Bids and Offers

*Municipal Utility X requires power supply for the next planning year starting June 1, 2014. It issues a Request for Proposal ("**RFP**") for electric supply averaging 10 MW per hour for 24 hours seven days a week at a fixed price and delivered at the ISO-New England Hub for the term of June 2014 through May 2015. The RFP structure requires the Town Board to approve the offers that Municipal Utility X desires to accept before the utility may execute a final sales agreement with the winning bidder(s). The terms of the RFP require that bids are due by 10:00 am on Tuesday, March 25th and must be held firm until Town Board approval is received. The lowest bidder will be notified by 4:00 pm on Tuesday, March 25th that its offer will be submitted for Town Board approval at its meeting scheduled for Wednesday, March 26th at 7:00*

pm. On Thursday March 27th, Municipal Utility X will confirm the results of the Town Board meeting and execute the power sales agreement.

On March 25th, several marketers submit offers to Municipal Utility X. Marketer A submits the lowest bid and is notified that its bid will be submitted to the Town Board for approval the next night. Municipal Utility X has obtained Town Board approval in previous RFPs, so Marketer A is confident that it will succeed on the instant RFP and will be the supplier.

Before Marketer A prepared its offer, it developed and implemented a hedging strategy. Given the risks associated with holding an irrevocable offer open and the volatility it has seen in the natural gas and power market in New England, Marketer A took a long position in a strip on a natural gas futures contract prior to submitting its bid. The natural gas futures position reduces the risk of an increase in the price of power (for which natural gas serves as a proxy) during the period between the time that the binding bid is submitted and the time that it is accepted. [28]

The Working Group recognizes that there are differences between asset classes of commodity derivative contracts, such as those transacted in energy and agricultural markets. These differences are largely operational in nature and relate to how markets for physically-settled energy and agricultural Referenced Contracts trade. The Commission has historically had concerns about potential disruptions to market integrity associated with participants holding long positions in the spot month in agricultural futures contracts. These concerns form some of the basic underpinnings of the Five Day Rule applied to certain enumerated agricultural futures contracts (referred to as the legacy physically-settled agricultural Referenced Contracts under the Proposed Rule). However, as addressed for other reasons in Section II.B.1.d, below, these concerns do ***not*** exist in energy markets from an economic or operational perspective.

Further, legitimate commercial hedging in energy markets would face significant harm if commercial energy firms using physically-settled Referenced Contracts were not permitted to utilize these Enumerated BFHs as cross-commodity hedges simply because they would not make or take delivery under the contract. This point cannot be overstated. Such a simplistic view fails to recognize that, due to the diverse and complex spectrum of grades and specifications in markets for crude oil and refined products, often times there is no available commodity derivative product listed for trading that can act as a direct hedge of the cash commodity being hedged, and that commercial energy firms need protection from exposure to price risk if the period during which purchases or sales of a commodity price overlaps with the spot month of the applicable physically-settled Referenced Contract.

Based on the foregoing, commercial energy firms should not be required to seek Non-Enumerated BFHs from the Exchanges pursuant to proposed Regulation 150.9 or from the Commission pursuant to proposed Regulation 150.3 for cross-commodity hedges of Unfilled Anticipated Requirements or Anticipated Merchandising. Requiring commercial energy firms to pursue Non-Enumerated BFHs for such industry-standard, day-to-day risk management

[28] This scenario is a variation of the facts set forth in Request No. 4 of the Working Group's BFH Petition (Binding, Irrevocable Bids and Offers). The Proposed Rule preliminarily determines that Request No. 4 would qualify for the Enumerated BFH for Anticipated Merchandising set forth in Appendix A, paragraph (a)(11). Proposed Rule at 11,611. The Working Group strongly supports this preliminary determination and notes that, similar to the example above, the facts presented in Request No. 4 involve a cross-commodity hedge, *i.e.,* natural gas futures are used to hedge exposure to price risk in electricity markets incurred through the submission of binding, irrevocable bids and offers. Given the preliminary determination that Request No. 4 of the BFH Petition would fall with the Enumerated BFH for Anticipated Merchandising, there is no policy basis for not permitting a commercial energy firm from using the Enumerated BFH for Anticipated Merchandising set forth in Appendix A, paragraph (a)(11) as a cross-commodity hedge for such transactions.

activities will not only harm legitimate hedging activity in energy markets by injecting uncertainty and delay into the process, it will likely result in a deluge of Non-Enumerated BFH applications being submitted by a broad array of commercial energy firms which would be in contrast to the Commission's expectation that the non-enumerated process would only be utilized in "rare and exceptional" circumstances.

In light of the foregoing, the Working Group requests that the Commission clarify that the Enumerated BFHs for Unfilled Anticipated Requirements and Anticipated Merchandising may be utilized as cross-commodity hedges and revise Appendix A, paragraph (a)(5) as follows:

> (5) *Cross-commodity hedges*. Positions in commodity derivative contracts described in paragraph (2) of the bona fide hedging transactions or positions definition in § 150.1 or in paragraphs (a)(1) through (a)(4), ~~and~~ paragraphs (a)(6) through (a)(9), **and, with the exception of positions in agricultural core referenced futures contracts identified in Table 1 to paragraph (d) of §150.2, paragraphs (a)(10) and (a)(11)** of this appendix A may also be used to offset the risks arising from a commodity other than the cash commodity underlying a commodity derivative contract, provided that the fluctuations in value of the position in the commodity derivative contract, or the commodity underlying the commodity derivative contract, shall be substantially related to the fluctuations in value of the actual or anticipated cash position or pass-through swap.

The Enumerated Safeguards discussed in Section II.B.1.a, above, will protect against excessive speculation and potential abuse by market participants utilizing the Enumerated BFHs for Unfilled Anticipated Requirements and Anticipated Merchandising as cross-commodity hedges.

c. Commercial Hedgers That Can Demonstrate They Are Engaged in the Business of Merchandising Should Be Permitted to Use the Enumerated BFH for Anticipated Merchandising.

The Working Group supports the inclusion of an Enumerated BFH for Anticipated Merchandising in paragraph (a)(11) of Appendix A of proposed Part 150 of the CFTC Regulations. Merchandising plays a critical role in the physical supply chain in every commodity market, linking producers to processors and processors to wholesalers and consumers. With respect to present-day energy markets, entities engaged in merchandising activities often own, operate, and otherwise control assets that facilitate the production, movement, storage, and processing of physical energy commodities. These include vessels, barges, power plants, mines, train cars, tanker trucks, pipelines, storage, and terminal facilities as well as the capital, employees, and expertise to manage that infrastructure and operation.

In addition to physical commodity merchants and supply-chain logistics companies, a number of integrated energy companies and other commercial energy firms have (i) affiliates that are stand-alone legal entities or (ii) internal functional business units, which as part of their primary operations are engaged in the merchandising of energy commodities to others (collectively, "**Merchandising Affiliates**"). The Merchandising Affiliates act as a middleman in energy markets for purposes of purchasing, selling, storing, and physically taking or making delivery of energy commodities for purposes of optimizing the assets owned by corporate

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affiliates or functional business units within the same corporate entity as well as engaging in physical energy commodity transactions with unaffiliated third parties for their own account.[29]

With this in mind, if strictly construed, the proposed language of this Enumerated BFH might appear to foreclose certain commercial energy companies from utilizing this exemption to manage risk through the use of anticipated merchandising hedges. Specifically, the Enumerated BFH for Anticipated Merchandising specifically refers to entities that are "merchants," which is an undefined term. While the Working Group fully supports the application of this proposed Enumerated BFH to entities that are physical commodity merchants and supply chain logistics companies, this hedge exemption should also apply to the limited set of other commercial energy firms that genuinely engage in merchandising activities and that can demonstrate the ability to make and take physical delivery of physical commodities, store, or move the underlying commodity.[30]

The Working Group appreciates the diverse set of Enumerated BFHs available to integrated energy companies and other commercial firms that can be utilized to facilitate the hedging needs of various aspects of their business, such as upstream and downstream operations. However, the Commission should be careful not to overlook the need for commercial firms that are credibly engaged in the business of merchandising to seek relief from federal position limits for such activities through the Enumerated BFH for Anticipated Merchandising.

Absent such relief, integrated energy companies and other commercial firms who seek a hedge exemption from applicable federal position limits for anticipated merchandising activities would need to pursue a Non-Enumerated BFH from the Commission pursuant to proposed Regulation 150.3 or an Exchange pursuant to proposed Regulation 150.9. While likely not the Commission's intention, restricting the ability of such entities to utilize the Enumerated BFH for Anticipated Merchandising would (i) *create a playing field that is not level by putting integrated energy companies and other commercial firms at a competitive disadvantage to those market participants who are able to utilize this hedge exception, and (ii) have the unintended consequence of creating a regulatory barrier to entry in a critically important segment of the energy industry*.

In light of these concerns, the Working Group requests that the Commission expressly clarify that the Enumerated BFH for Anticipated Merchandising may be utilized by any market participant who is regularly engaged in merchandising and is entering in the anticipated merchandising hedge solely for purposes hedging such commercial activities. The Working Group offers the following proposed revision of paragraph (a)(11) of Appendix A of proposed Part 150 for the Commission's consideration:

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[29] For instance, a Merchandising Affiliate of an integrated energy company could enter into a physical (short) commitment in cash markets to supply an end-use consumer in Latin America with its requirements for finished gasoline. The Merchandising Affiliate could have initially entered into this physical supply commitment with the intent of providing an opportunity to optimize the assets of a downstream refining affiliate. However, if the downstream refining affiliate does not pursue this opportunity for its own commercial or operational reasons, the Merchandising Affiliate must procure finished gasoline from an unaffiliated, third-party supplier(s) to meet its obligations to supply the requirements of the end-use consumer in Latin America.

[30] Such firms might include integrated energy companies and other commercial firms (*e.g.*, refiners with commercial trading operations, unregulated marketing affiliates of public utility holding companies) that are regularly engaged in merchandising, but have many other business activities. In the power sector, for example, a number of public utility holding companies have unregulated energy marketing affiliates who are engaged in the business of merchandising in wholesale and retail markets for power and natural gas. With respect to wholesale power markets, due to applicable rules and regulations of the Federal Energy Regulatory Commission, these entities must function separately and independently from any regulated utility affiliates.

(11) *Hedges of anticipated merchandising*. Long or short positions in commodity derivative contracts that offset the anticipated change in value of the underlying commodity that a person anticipates purchasing or selling, provided that:

(A) The position in the commodity derivative contract does not exceed in quantity twelve months' of current or anticipated purchase or sale requirements of the same cash commodity that is anticipated to be purchased or sold; and

(B) The person ~~is a merchant~~ handling the underlying commodity that is subject to the anticipatory merchandising hedge **is a producer, processor, commercial user, or a merchant (a "Commercial Entity")**, and that ~~such merchant~~ **such Commercial Entity** is entering into the position solely for purposes related to its merchandising business and has a demonstrated history of buying**,** ~~and~~ selling**, or using** the underlying commodity for its merchandising business.

d. The Commission Should Clarify That the Enumerated BFH for Anticipated Merchandising Applies to Certain Frequently-Utilized, Industry-Standard Hedging Practices.

Notwithstanding its broad support for the Proposed Rule, the Working Group notes that the failure to recognize certain industry-standard hedges of merchandising activity as falling within the Enumerated BFH for Anticipated Merchandising in Appendix A, paragraph (a)(11) to proposed Part 150 will harm commercial hedging activity in energy markets. The adoption of a regulatory framework that would require commercial energy firms to pursue Non-Enumerated BFHs for such industry standard risk reducing practices discussed below will not only inject uncertainty and impose additional costs to commercial hedging activities in energy markets, it will have the unintended consequence of potentially overwhelming the Exchanges and the Commission with Non-Enumerated BFH applications. Such a result would be contrary to the expectation that the non-enumerated process would be used only in "rare and exceptional" circumstances.[31]

(i). The Storage Hedge.

Energy storage is a critical and highly valued infrastructure asset. Storage hedges are one of the most common and highly-utilized risk reducing practices in the energy industry. It is used by commercial firms across all sectors of the energy industry – oil, refined products, natural gas, and power – from state-regulated, local natural gas distribution companies to integrated energy companies to global physical commodity merchants.

The Proposed Rule suggests that commercial energy firms seeking to utilize storage hedges could pursue Non-Enumerated BFH treatment. However, in light of the pervasive use of storage hedges by entities throughout the physical supply chain and the Commission's clarified approach to BFH activities, the Proposed Rule does not provide for the record any explanation or policy-based justification why such hedging activity would not, or should not, fall within the Enumerated BFH for Anticipated Merchandising.

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[31] *See* Proposed Rule at 11,650.

Hedges of storage are not limited to the actual commodity being stored. They also include hedges of storage assets that a commercial hedger may own or lease or anticipates owning or leasing. Storage hedges enable commercial hedgers to reduce exposure to price risk with respect to a commodity that is purchased and injected into storage as well as withdrawn and sold to customers, and they also help establish (and lock in) the value of the asset – the storage lease. The market value is largely determined by the calendar spread at that moment. The ability of a commercial hedger to protect itself from an adverse change in prices that determine an asset's value is clearly contemplated by the language of CEA Section 4a(a)(c)(2)(A)(iii)(1), which directs the Commission to define "*bona fide* hedging transaction or position to include the hedging of the value of assets that a party owns."

The example set forth below highlights how hedges of energy storage represent legitimate risk reduction activity of a commercial enterprise.

<u>*Storage Hedge - Scenario No. 1*</u>

*On July 1st, Company A enters into a one-year lease on 1 bcf of natural gas storage near Chicago Citygate, which it intends to use to store gas to supply to local distribution companies ("**LDCs**") over the coming winter season. On July 1st, the price of the October natural gas contract is $4.32, indicating that Company A could inject natural gas into storage in October at $4.32 for a total cost of $4,320,000. Also on July 1st, the December-January-February strip ("**December-February Strip**") is priced at $4.51, indicating that Company A could withdraw natural gas from storage to supply the LDCs at $4.51 for gross revenue of $4,510,000. As Company A may not be able to enter into agreements to buy and sell physical natural gas to replicate its expected winter activity, it uses derivatives contracts as a temporary substitute to protect itself against the risk that prices for October move adversely relative to prices for the December-February Strip. It will buy October futures and sell an equal amount of the December-February Strip and lock in the differential and in doing so, hedge the value of the one-year storage lease it has entered into.*

<u>*Storage Hedge - Scenario No. 2*</u>

Storage contracts are used to serve retail load and manage power plant load. Storage is important as a hedge against load swings are critical to providing reliable supply to retail customers (particularly in winter months). Financial NYMEX swaps can be used to hedge physical volumes that are injected into storage in the summer (April-October) months for later withdrawal in the winter (November-March) months. For example, if 1.2 bcf of gas was injected into retail storage during summer months at $2.00 and was to be withdrawn in the winter months 240k dth/month during November-March, a financial NYMEX hedge can be sold in those winter months at $2.50 to protect the physical gas price risk if winter weather were to be mild and prices were to decline. Often, there is a summer/winter price differential that can be locked in to hedge and realize value on the storage contract. In the previous example, the hedge would realize $.50/dth of value. If a winter gas hedge was not entered into and winter gas prices averaged $1.50, the storage holder would lose $.50/dth of value on the gas that was injected into storage. In many cases, retail access programs include the storage contracts with an express withdrawal requirement during winter months. Inventories must be reduced to certain levels during the winter period. In some cases, winter prices can fall below the price of the injected gas. The financial NYMEX hedge protects if winter spot prices were to fall.

> *The same storage contracts may be critical to dynamically dispatch certain gas plants. Absent the use of storage contracts, power generation companies may be subject to hourly penalties and must profile their gas based on expected run schedule. Storage is used to limit these penalties while also allowing a power plant to flexibly operate. These flexible operations are critical to allow the power markets to dispatch the lowest cost unit instead of relying on baseload units. In the Texas market, nominations are done on an hourly basis and storage contracts are essential to profiling the gas. For example, a plant forecasted to run 16 hours in the gas day at 5,000/hr., requires a purchase of 80,000 dth for the day flowing on a 1/24th flow rate of 3,333 dth/hr. The storage contract permits the power generation company to profile the nominations based on run schedule. In this case, the entity would inject 3,333/hr. for the 8 hours the plant is offline and withdraw 1,667 dth/hr. for the 16 hours the plant is online – matching the run profile of the plant. This operation requires a certain volume of gas (pad gas) injected into storage to maintain operational flexibility on a particular day. To manage the price risk of the pad gas once it is injected into the ground, financial NYMEX swaps can be sold at the end of the contract term to preserve storage value. NYMEX gas is sold at the end of the term of the contract because that gas is not scheduled to be withdrawn during the term of the contract.*

Although storage hedges can be static, commercial energy firms often make dynamic decisions about how and when to hedge storage capacity.[32] Not allowing commercial energy firms to utilize these industry-standard hedges on an enumerated basis because they are "anticipatory" in nature or viewed as a form of "merchandising" – or both – could result in storage assets being underutilized, which could increase volatility in physical and financial markets for energy commodities that ultimately could translate into higher costs for consumers.

The omission of enumerated treatment for storage hedges in the Proposed Rule sharply contrasts with the treatment of this activity in the final rule issued by the Commission in November 2011, which was subsequently vacated by federal courts.[33] The Vacated Final Rule included an enumerated hedge exemption that was characterized as anticipated merchandising in then-proposed Part 151 of the CFTC Regulations, but which expressly applied to storage transactions.[34] The Working Group requests that the Commission take a similar approach in

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[32] These factors include, among others: (i) facility-specific operating characteristics; (ii) weather; (iii) regional storage constraints; (iv) pipeline maintenance; (v) "force majeure" events; and (vi) weekly U.S. Energy Information Administration natural gas storage numbers.

[33] On November 18, 2011, the CFTC issued a final rule establishing federal speculative position limits for 28 exempt and agricultural commodity futures and options contracts and their economically equivalent contracts. *See* Final Rule and Interim Final Rule, *Position Limits for Futures and Swaps*, 76 Fed. Reg. 71,626 (Nov. 18, 2011) ("**Vacated Final Rule**"). On September 28, 2012, the United States District Court for the District of Columbia vacated and remanded this final rule. *See Int'l Swaps and Derivatives Ass'n, et al. v. U.S. Commodity Futures Trading Comm'n*, 887 F. Supp. 2d 259 (D.D.C. Sept. 28, 2012), *appeal dismissed*, 2013 U.S. App. LEXIS 22618 (D.C. Cir. Nov. 6, 2013).

[34] In relevant part, the Vacated Final Rule stated as follows:

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any final rule issued in this proceeding by clarifying that hedges of storage may qualify for the Enumerated BFH for Anticipated Merchandising if applicable conditions are met.[35]

(ii). Hedges Designed to Lock-In Basis Differentials Associated with Unfixed Priced Physical Purchase or Sale Commitments.

The Working Group appreciates that the Proposed Rule's preliminary determination that certain anticipated merchandising activity addressed in the BFH Petition may qualify for BFH treatment through the enumerated exemption set forth Appendix A, paragraph (a)(11) of proposed Part 150.[36] However, the Working Group is concerned that the Proposed Rule does not recognize critically important hedging associated with managing exposure to price risk involving certain unfixed priced physical purchase or sale commitments (*i.e.,* floating or variable price commitments).

Each link in the supply chain involves a purchase transaction and a sale transaction, each of which forms a connection point to the adjacent link in the supply chain – generally at different locations. Commercial energy firms use commodity derivatives to manage price risk for each connection, but they often cannot do so simultaneously. As a consequence, a commercial energy firm may enter into a purchase transaction before it has arranged the sale

> The Commission recognizes that in some circumstances, such as when a market participant owns or leases an asset in the form of storage capacity, the market participant could establish market positions to reduce the risk associated with returns anticipated from owning or leasing that capacity. In these narrow circumstances, the transactions in question may meet the statutory definition of a bona fide hedging transaction. However, to address Commission concerns about unintended consequences (*e.g.,* creating a potential loophole that may result in granting hedge exemptions for types of speculative activity), the Commission will recognize anticipatory merchandising transactions as a bona fide hedge, provided the following conditions are met: (1) The hedger owns or leases storage capacity; (2) the hedge is no larger than the amount of unfilled storage capacity currently, or the amount of reasonably anticipated unfilled storage capacity during the hedging period; (3) the hedge is in the form of a calendar spread (and utilizing a calendar spread is economically appropriate to the reduction of risk associated with the anticipated merchandising activity) with component contract months that settle in not more than twelve months; and (4) no such position is maintained in any physical-delivery Referenced Contract during the last five days of trading of the Core Referenced Futures Contract for agricultural or metal contracts or during the spot month for other commodities.

Vacated Final Rule at 71,646.

[35] In 2013, subsequent to the Vacated Final Rule, the Commission's focus on storage hedges shifted from the use of storage by commercial energy firms to providers of "off-farm" storage and the rents they could collect from operating storage capacity. *See* December 2013 Release at 75,719. This was not the basis upon which the Commission approved an anticipated merchandising hedge for storage in the Vacated Final Rule and should not be the basis on which it is considered in this rulemaking. Given the capital intensive nature of owning a storage facility (*i.e.,* fixed cost of the storage facility and the variable costs for labor and fuel, in addition to other costs such as insurance), commercial energy firms generally are not in the business of acting as third-party lessors of storage. Rather, commercial energy firms' focus is on managing their exposure to price risk and locking in the value of a critical energy infrastructure asset that they (i) own or anticipate owning or (ii) lease or anticipate leasing as part of their wider efforts to meet their obligations to purchase or sell physical energy commodities and, where applicable, optimize their own production and processing operations. Accordingly, the Commission should consider the instant request for clarification in this context, which is materially different (and clearly distinguishable) from when the Commission last addressed this issue in the December 2013 Release.

[36] Proposed Rule at 11,611 (preliminarily determining that Request Nos. 4 and 5 of the BFH Petition fall within the Enumerated BFH for Anticipated Merchandising).

transaction. The very strength of the supply chain depends on firms accepting and capably handling risks from this timing mismatch.

By failing to recognize that when a commercial energy firm uses commodity derivatives to manage price risk associated with a purchase at a moment when the same firm does not have an offsetting sale (a "**Unpriced Physical Purchase or Sale Commitments**") (or when a firm manages price risk with a sale before it has a corresponding purchase),[37] the Proposed Rule ignores commercial realities and frustrates a critical function performed by commercial firms transacting in the middle of the energy supply chain. This lack of recognition suggests the Commission has overlooked an extremely common use of commodity derivatives by commercial energy firms to manage price risk that are routinely conducted in numerous markets for energy and other commodities across the globe.

The following example presents a transaction that is routinely conducted in numerous markets and commodities daily.

Example – Unpriced Physical Purchase or Sale Commitments

*Company A purchases a product in a particular location ("**Location 1**") and does so at an index price as is customary in that market. Based on its operations in the physical supply chain, Company A is experienced in all of the elements of the movement and storage of physical commodities (e.g., owning ships, chartering vessels, scheduling deliveries, conducting quality inspections).*

*The current market price for the commodity in Location 1 is at a discount to the market price at another location ("**Location 2**") at the time the product could be delivered there. The discount is sufficiently large to cover the logistical costs of moving the product from Location 1 to Location 2 and to generate a profit to Company A. Based on these market signals, Company A purchases the product in Location 1 at a floating index price. To lock in the economics of the transaction, Company A takes a long position in a commodity derivative contract on the purchase price index (at Location 1) and sells a derivative on the expected sales price index (at Location 2). In industry parlance, it has "locked in the basis."*

If Company A fixes its purchase price at Location 1 before selling the product in Location 2, it will liquidate its long-side hedge. At that time, it will own a fixed price contract (or inventory) in Location 2 and short hedge against it. Alternatively, if it sells the product at a fixed price in Location 2, it will liquidate its short-side hedge. Or, if it sells the product in Location 2 at a floating price, it will leave its basis hedge in place.[38]

[37] As noted in the Proposed Rule, the Working Group first raised this issued in connection with Request No. 3 in its BFH Petition. Proposed Rule at 11,611. The Working Group and several other commercial industry groups and market participants have advocated for an Enumerated BFH for this commercial hedging practice. This issue is important to the industry.

[38] Similarly, a commercial energy firm could purchase fixed price natural gas at distressed prices with open sales strategy. The commercial energy firm may have the option to place the natural gas in storage or park it on a pipeline. However, an inherent element of this strategy is the ultimate movement of the distressed priced gas to markets where natural gas is trading at premium and where the commercial energy firm has a network of established customer relationships who will be buy it for their own commercial use of consumption. As a consequence, the commercial energy firm will take long and short positions in commodity derivative contracts to "lock the basis" and preserve the economics of the movement of distressed gas from a location where it was purchased to a location where price signals and market demand indicate it there will be interested purchasers.

The transaction structure presented in the example above forms the basis in which energy commodities routinely move within North America, and from the U.S. to the Caribbean, Latin America, South America, Europe, and Asia and *vice versa* every day. As noted above, parties often enter into one side of a transaction before arranging the other based upon market prices and their ability to "lock in the basis" and ensure the economics of the transaction. Such transactions facilitate the requirements of parties on either end of the physical supply chain. Producers sell on their schedule and refiners purchase on theirs. The ability to wait until there is a match of buyer and seller simply does not reflect how commerce is actually conducted in national and international markets for energy commodities.

Commodity derivatives used to hedge exposure to price risk associated with Unpriced Physical Purchase or Sale Commitments fall within the definition of BFH set forth in proposed Regulation 150.1. They (i) represent a substitute for transactions made or to be made in the physical marketing channel, (ii) are economically appropriate to the reduction of price risk in the conduct and management of a commercial enterprise, and (iii) arise from the potential change in value of assets that the purchaser owns, produces, manufactures, processes or merchandises, or anticipates owning, producing, manufacturing, processing, or merchandising. As mentioned above, such hedge transactions are widely used by commercial firms to achieve price certainty through, among other things, locking in basis differentials.

The Proposed Rule does suggest that firms can seek Non-Enumerated BFH treatment for derivatives to manage Unpriced Physical Purchase or Sale Commitments.[39] However, as discussed elsewhere herein, reliance on the Non-Enumerated BFH process will impose procedural hurdles, uncertainty, and additional costs on a critically important function of the supply chain in the U.S. economy as well as having the unintended consequence of the Non-Enumerated BFH process being regularly utilized for industry-standard hedging activities. Ongoing uncertainty with respect to the timely (or ultimate) approval of Non-Enumerated BFHs for Unpriced Physical Purchase or Sale Commitments would force firms to price such risk into the underlying physical transaction. This would result in (i) a higher net price of the commodity for consumers and (ii) the physical market transaction potentially not occurring.

The Commission can remedy this shortcoming in any final rule issued in this proceeding by clarifying that the hedges of Unpriced Physical Purchase and Sale Commitments fall within the Enumerated BFH for Anticipated Merchandising set forth in Appendix A, paragraph (a)(11). In the alternative, the Commission could clarify that a firm can leg-in to the Enumerated BFH for Offsetting Unfixed-Price Cash Commodity Sales and Purchases set forth in Appendix A, paragraph (a)(2). This guidance would mitigate the timing problem of not having offsetting purchase and sales when a commercial firm needs to handle the pricing of a sale or a purchase.

[39] Proposed Rule at 11,612.

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(iii). Hedges of Calendar Month Average Transactions with Customers in the Energy Supply Chain.[40]

As discussed above, the Commission should be careful to ensure that the federal regime for position limits does not frustrate the use of commodity derivatives by commercial energy firms to manage exposure to price risk down the physical supply chain from the producer through to the consumer. One industry-standard practice in oil and gas markets involves the use of the calendar month average ("**CMA**") hedges to manage exposure to price associated with underlying purchases and sales of crude oil or natural gas. In this respect, CMA price structures are used in a vast amount of cash-market transactions in oil and gas markets because it allows users to (i) establish the spot price based on a differential to the forward price when there is no reliable market-established price, and (ii) convert to "trading month average" pricing (*i.e.,* the expiring listed futures contract does not trade through the spot month). In these situations, the producer (purchaser) is looking to hedge on a forward basis the differential between (a) the benchmark forward prices established in the futures markets and (b) the spot price.

Although oil and gas producers may be able to use the Enumerated BFH for Unsold Anticipated Production set forth as paragraph (a)(1) in Appendix A of proposed Part 150 to hedge sales of oil or gas to cover sales of production at CMA prices, the persons to whom they might sell such production for resale to others cannot. Left uncorrected, this constraint will harm the ability of commercial energy firms to hedge against price risk associated with supply chain transactions (i) that utilize this important and industry-standard pricing structure or (ii) where an actual or potential mismatch in pricing terms exists and CMA hedges are viewed as the best available practice for mitigating exposure to such risk.

The following is a stylized explanation of how a commercial energy firm might use commodity derivatives to hedge its exposure to price risk for physical barrels of crude oil it has purchased from a producer at CMA prices.

Purchases from a Producer and Resale in the Energy Supply Chain

Firm A contracts with a producer to buy light sweet crude oil (WTI) in the month of July 2020. The forward contract provides that the producer will deliver approximately 88,000 barrels to Firm A for a purchase price based on the calendar month average of settlement prices for the NYMEX Light Sweet Crude Oil (CL) futures contract in July. Firm A wants to book this purchase at a fixed price as of the date of the forward contract, June 1, 2020, but also wishes to meet its customers need by offering the requested CMA pricing. To mitigate its exposure to price risk associated with the purchases of WTI from the producer, Firm A implements the following hedge strategy:

On the contract date, Firm A buys NYMEX CL futures for the front month that will price in July, which CL futures are for August 2020 and, following the last day of trading for that contract, for September 2020. In each business day in July, Firm A partially unwinds that position. These cover Firm A's exposure to price risk associated with the amounts payable to the producer to purchase the light sweet crude oil at a CMA price.

[40] As noted in the Proposed Rule, the Working Group first raised this issued in Request No. 7, Scenario 2 in its BFH Petition. *See* Proposed Rule at 11,611.

	Date	Aug Lots	Aug Price	Sep Lots	Sept Price	Difference	Absolute Dollars
Opening Trade	1-Jun	56	33.00	32	34		2,936,000
Pricing Trades	1-Jul	-4	-32.56			-0.44	-1760
	2-Jul	-4	-33.11			0.11	440
	6-Jul	-4	-34.10			1.10	4400
	7-Jul	-4	-33.75			0.75	3000
	8-Jul	-4	-33.10			0.10	400
	9-Jul	-4	-32.50			-0.50	-2000
	10-Jul	-4	-32.08			-0.92	-3680
	13-Jul	-4	-32.02			-0.98	-3920
	14-Jul	-4	-31.60			-1.40	-5600
	15-Jul	-4	-31.40			-1.60	-6400
	16-Jul	-4	-32.05			-0.95	-3800
	17-Jul	-4	-32.70			-0.30	-1200
	20-Jul	-4	-33.10			0.10	400
	21-Jul	-4	-33.50			0.50	2000
	22-Jul			-4	-33.60	-0.40	-1600
	23-Jul			-4	-33.85	-0.15	-600
	24-Jul			-4	-34.20	0.20	800
	27-Jul			-4	-34.10	0.10	400
	28-Jul			-4	-34.75	0.75	3000
	29-Jul			-4	-34.60	0.60	2400
	30-Jul			-4	-34.20	0.20	800
	31-Jul			-4	-34.35	0.35	1400
Check (lots)		0		0			
Check (price)			Average of closing price		33.24		
					Total Price		2,924,880
					Total Barrels		88,000
					Ttl Price/Brl		33.24

CMA hedges fall within the definition of BFH set forth in proposed Regulation 150.1. The producer in the example above, as is often the case, simply seeks to sell the oil to purchasers on a CMA basis. To hedge its risk on the purchase from the producer, Firm A enters into the futures trades identified above. Firm A's activity falls within the definition of BFH as it: (i) represents a substitute for transactions made or to be made in the physical marketing channel; (ii) is economically appropriate to the reduction of price risk in the conduct and management of a commercial enterprise; and (iii) arises from the potential change in value of assets that the purchaser owns, produces, manufactures, processes or merchandises, or anticipates owning, producing, manufacturing, processing, or merchandising.

The Proposed Rule suggests that a commercial energy firm can seek a Non-Enumerated BFH to hedge merchandising transactions of energy commodities where the underlying transaction uses CMA pricing.[41] However, this statement fails to recognize that CMA pricing of physical oil or gas merchandising transactions is a prevailing, industry-standard practice. In other words, the use of this pricing structure in physical transactions and for hedges of such transactions is the norm in oil and gas markets, not the exception.

[41] Proposed Rule at 11,612.

As discussed elsewhere herein, if the Commission requires commercial energy firms to use the Non-Enumerated BFH process for CMA hedges, it will inject procedural hurdles, uncertainty, and additional costs into a fundamental hedging practice used throughout the oil and gas supply chain. Moreover, given the prevalence of CMA pricing in physical oil and gas markets, it is foreseeable that many commercial energy firms – from physical commodity merchants to integrated energy companies to energy marketers – will find it necessary to request a Non-Enumerated BFH treatment for hedges of physical transactions that utilize CMA pricing. Such a result would be far from the Commission's expectation that the Non-Enumerated BFH process will be used only in "rare and exceptional" circumstances.

Based on the foregoing, any final rule issued in this proceeding should clarify that CMA hedges fall within the Enumerated BFH for Anticipated Merchandising set forth in Appendix A, paragraph (a)(11) of proposed Part 150 if applicable conditions set forth therein are met. Such a clarification is an easy and efficient way for the Commission to provide certainty and facilitate the implementation of the federal regime for position limits by eliminating administrative barriers for obtaining a BFH exemption to protect against price risk associated with a fundamental pricing practice in physical markets for oil and gas.[42]

d. The Five Day Rule.

The Working Group supports the Commission's actions to eliminate the Five Day Rule from the proposed regulatory framework for federal speculative position limits.[43] The Working Group also supports the delegation of authority to the Exchanges allowing them to use their discretion to apply the Five Day Rule when addressing exemptions from exchange-set limits pursuant to proposed Regulation 150.5(a)(2)(ii)(D).[44]

(i). The Application of the Five Day Rule to Physically-Settled Referenced Contracts for Energy Commodities Is Neither Appropriate Nor Justified.

The Working Group appreciates that the Proposed Rule clarifies that the strict application of the Five Day Rule to requests for exemptions from exchange-set limits involving physically-settled Referenced Contracts for energy commodities is not appropriate given the unique operation of energy markets.[45] This approach properly and accurately recognizes that the Exchanges have a variety of tools to protect price convergence during the spot period.[46]

The Five Day Rule prohibition against holding a physically-delivered futures contracts as a BFH position into the spot month is currently set forth in existing Part 150 of the CFTC Regulations, which applies exclusively to legacy agricultural futures contracts. In agricultural futures markets, physically-settled futures contracts trade into (and at least partially through) the delivery month. Participants that remain in Chicago Board of Trade ("**CBOT**") agricultural futures contracts close to or during the delivery month are potentially subject to a "delivery

[42] The Working Group notes that the Enumerated Safeguards will prevent excess speculation and protect against potential abuse associated with permitting commercial energy firms to rely on the Enumerated BFH for Anticipated Merchandising for CMA price hedges.

[43] Proposed Rule at 11,612-613; *see* February 2014 Letter at 51-53; July 2016 Letter at 7-9; February 2017 Letter at 18-19.

[44] Proposed Regulation 150.5(a) deals with exchange-set limits and exemptions therefrom involving commodity derivatives contracts to subject to federal limits established under proposed CFTC Regulation 150.2.

[45] In the context of this discussion, the use of the term physically-settled Referenced Contract refers to a physically-delivered futures contract that is subject to federal limits set forth in proposed Regulation 150.2.

[46] Proposed Rule at 11,612.

notice." The "delivery notice" can occur on the second to last business day of the month preceding the contract month for the prompt futures contract (this is also known as "**First Notice Day**").

Once an agricultural market participant holds a position past First Notice Day, from that day forward through expiration of trading in the prompt month futures contract, the exchange may designate them to make or take delivery of the actual commodity. Thus, there is a policy rationale to prohibit market participants from carrying a hedge-exempt sized position in physically-settled agricultural futures contract positions in the last five days of trading when they may not be prepared to make or take delivery. Being served with a delivery notice under such circumstances could be disruptive to the markets.

Physically-settled Referenced Contracts for energy commodities do not trade into the delivery month.[47] Rather, these contracts cease trading and settle days, if not weeks, before the delivery month begins.[48] Consequently, the risk that a party could be called upon during the spot period to fulfill a delivery obligation when it is not commercially prepared to do so simply does not exist. Given this operational distinction, concerns regarding potential disruptions during the spot period analogous to those in agricultural markets are not applicable to energy markets.

Finally, there is no apparent economic justification for forcing participants in energy markets to exit the contract that provides the best hedging tool into a different contract month or into a cash-settled commodity derivative contract. Because such cash-settled derivatives contracts do not go to delivery and settle at or prior to expiry of physically-settled Referenced Contracts, the application of the Five Day Rule by an Exchange would leave a commercial energy firm or other energy market participant fully exposed to price risk prior to actual physical delivery.

(ii). The Waiver Guidance Set Forth in Appendix B, Paragraph (b) Should Only Apply to Physically-Settled Referenced Contracts Expressly Designated by an Exchange as Being Subject to the Five Day Rule.

As part of the Exchanges' authority and discretion to apply the Five Day Rule pursuant to proposed Regulation 150.5(a)(2)(ii)(D), the Working Group appreciates that the Proposed Rule also includes guidance in Appendix B, paragraph (b) addressing circumstances when waiver of the Five Day Rule may be appropriate. In order to provide regulatory certainty and avoid harm to legitimate commercial hedging activity in energy markets, the Working Group requests that the Commission address and clarify the applicability of the waiver guidance in any final rule issued in this proceeding for the following reasons.

First, the waiver guidance in Appendix B, paragraph (b) does not clearly specify the circumstances under which the Exchanges would be expected to adhere to such guidance. If an Exchange opts not apply the Five Day Rule to a request for a BFH involving a physically-settled Referenced Contract pursuant to proposed Regulation 150.5(a)(2)(ii)(D), for instance, it is not clear whether such Exchange would be expected to follow the waiver guidance or whether

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[47] February 14 Letter at 52.

[48] For example, the last trading day and settlement of the May 2020 NYMEX CL futures contract, a physically-settled Referenced Contract, took place on April 21, 2020. Pursuant to NYMEX Rule 200105 (Delivery Procedures), Notices of Intention to Deliver or Accept with respect to the NYMEX CL futures contract were provided on April 22, 2020, the first business day after the final day of trading. Notices of Intention to Deliver or Accept were allocated among counterparties by matching the size of positions (to the extent possible) on April 23, 2020, the second business day after the final day of trading. Actual delivery of light sweet crude oil under the NYMEX CL could not take place any earlier than May 1, 2020 – *nine days after the final day of trading* - and must be completed by no later than May 31, 2020.

it could simply take no further action. *Second* and relatedly, to the extent an Exchange follows the waiver guidance, paragraph (b)(3) of Appendix B contemplates that the market participant who has been granted waiver must take the physically-settled Referenced Contract it is holding as BFH in the spot month to physical delivery.

If the Exchanges were expected to follow the paragraph (b)(3) guidance when reviewing BFH applications involving physically-settled Referenced Contracts for energy commodities, it would harm commercial energy firms by effectively prohibiting them from holding physically-settled Referenced Contracts as a BFH in the spot month for purposes of engaging in, among other things, (i) hedges of unfilled anticipated requirements, (ii) cross-commodity hedges in crude or product markets discussed in Section II.B.1.b, above, (iii) storage hedges in crude and natural gas markets, (iv) calendar month average price hedges, and (v) potentially harm their ability to enter into (a) exchange for physical ("**EFP**") transactions or (b) alternative delivery procedures ("**ADP**"), which generally are used when counterparties prefer not to perform under the exact terms of a futures contract.[49]

To avoid harm to commercial hedging activity in energy markets and provide regulatory certainty, the text of Appendix B, paragraph (b) should be revised to unambiguously clarify that guidance for waiver of the Five Day Rule would only apply to physically-delivered futures contracts for energy commodities that are expressly designated as being subject to the Five Day Rule by an Exchange. If an Exchange does not expressly designate a physically-settled commodity derivatives contract as being subject to the Five Day Rule, then the application of the waiver guidance in Appendix B is moot. The Working Group notes that such a clarification would not in any way preclude or otherwise restrict the Exchanges from utilizing other measures available to them to manage and ensure the fair, orderly, and efficient expiry of a physically-settled Referenced Contract held as a BFH in the spot month.

e. The Proposed Process for Commission Review of Non-Enumerated BFH Determinations Granted by an Exchange Needs Adjustment to Be Fully Commercially Practicable.

The Working Group is concerned that the Commission review of Non-Enumerated BFH determinations as set forth in proposed Regulation 150.9(e), including its ability to stay pending applications, is not commercially practicable. Specifically, the Working Group is concerned that the Commission does not possess the internal the resources, nor do the individual Commissioners have sufficient time in their schedules, to review such Non-Enumerated BFH determinations pursuant to the ten-day or two-day review periods given that such a review process likely would be a daily rolling obligation, not a scheduled periodic obligation.

The inability to act on Non-Enumerated BFH determinations issued under proposed Regulation 150.9 in a prompt and timely manner would harm legitimate commercial hedging activity in energy markets. Energy markets are dynamic and change in real-time. By the time that the Commission formally reviews a stayed Non-Enumerated BFH determination, the commercial circumstances underlying the need for the proposed hedge exemption could be stale and, in the interim, the market participant was not able to hedge its position and was nakedly exposed to the identified exposure to price risk.

The Working Group suggests that an alternative process for Commission review of Exchange Non-Enumerated BFH determinations would be to utilize the annual Exchange rule enforcement review process.[50] The rule enforcement review process would provide the Commission with a forum to issue forward looking guidance to the Exchanges and to commercial hedgers on what types of hedging activities may not (or do not) qualify for treatment as a Non-

[49] *See, e.g.*, NYMEX Rule 538; IFUS Rule 4.06; CME Rules 770-79.

[50] See discussion of the Commission's rule enforcement review process in Section II.A.2, above.

Enumerated BFH. In addition, it would eliminate regulatory and commercial uncertainty with respect to market participants' concerns that the Commission could micromanage the streamlined Non-Enumerated BFH process in proposed Regulation 150.9.

Finally, the Working Group requests that the Commission clarify that its review of Non-Enumerated BFH determinations pursuant to proposed Regulation 150.9(e) would only apply to initial determinations and not subsequent applications, unless facts and circumstances are materially different.

f. The Commission Should Allow the Exchanges to Accept Applications for Non-Enumerated BFHs in Advance of the Compliance Date Established in a Final Rule.

The Working Group requests that the Commission permit the Exchanges to accept for review and grant Non-Enumerated BFHs pursuant to proposed Regulation 150.9 in advance of the date that compliance would be required by any final rule issued in this proceeding. Permitting the Exchanges to accept BFH applications in advance of the compliance date will ensure that an orderly process is in place to process such applications and would prevent a "logjam" situation that stretches or overwhelms the Exchanges' own resources resulting from a submission of applications by a large number of market participants on or just before the compliance date.

2. The Spread Exemption.

The Working Group supports the adoption of an exemption for enumerated spread transactions set forth in proposed Regulations 150.1 and 150.3(a)(2) (each, a "**Spread Exemption**"). The Working Group requests that, in any final rule issued in this proceeding, the Commission expand the list of enumerated spread transactions set forth in proposed Regulation 150.1 to include transactions that involve the same underlying commodity, otherwise known as "intra-commodity spreads."

As drafted, the Proposed Rule notes that the Spread Exemption would cover a single, common type of intra-commodity spread, *i.e.,* calendar spreads.[51] Although the Proposed Rule is silent on this point, the Working Group assumes this statement refers to intra-commodity spreads that involve Referenced Contracts of the same class (*i.e.,* physically-settled vs. physically-settled or cash-settled vs. cash-settled). The Working Group requests that, in the context of the proposed Spread Exemption, the Commission permit market participants to engage in intra-commodity spreads that not only involve transactions across exchanges, but also across classes of Referenced Contracts, *i.e.,* one-leg is a physically-settled Referenced Contract and the other leg is cash-settled Referenced Contract.

The inclusion of "intra-commodity spread" in the definition of spread transaction would provide market participants – particularly those in energy markets – with needed clarity and certainty that they may enter into spreads in the same underlying commodity (i) in the same class of Referenced Contract, (ii) across classes of Referenced Contracts, or (iii) across markets in Referenced Contracts (*i.e.,* on different Exchanges) in the same or different calendar months.[52]

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[51] Proposed Rule at 11,622.

[52] Proposed Rule at 11,633 (noting that intermarket spreading would be permitted under the federal regime set forth in the Proposed Rule and should address concerns regarding the loss of liquidity under certain commodity derivative contracts).

For example, trading activity across exchanges and between physically-settled Referenced Contracts and their look alike cash-settled Referenced Contracts (*e.g.*, NYMEX Henry Hub Natural Gas (NG) futures contract and IFUS Henry LD1 Fixed Price futures) is highly correlated and, as a result, helps promote price convergence and liquidity during the spot month between cash markets and derivative markets in the same underlying commodity.[53] In light of the common policy rationale supporting the inter-market spreads and intra-commodity spreads, the Working Group requests the Commission provide clarity and regulatory certainty by amending the language of definition of "spread transaction" set forth in proposed Regulation 150.1 to expressly include intra-commodity spreads. The Working Group proposes the following revisions to text of definition of "spread transaction" set forth in proposed Regulation 150.1:

> *Spread transaction* means either ~~**a calendar spread,**~~ **an intra-commodity spread, including, but not limited, to a calendar spread**, intercommodity spread, **inter-exchange spread,** quality differential spread, processing spread, product or byproduct differential spread, or futures option spread

3. Referenced Contracts.

a. The Commission Should Limit the Extraterritorial Reach of the Proposed Regulatory Framework for Federal Position Limits to Referenced Contracts Listed for Trading on U.S.-Based Exchanges and Swaps Subject to CEA Section 2(i).

Pursuant to proposed Regulation 150.2(h), the proposed federal regime for federal speculative position limits will extend to Referenced Contracts, including positions executed on or pursuant to the rules of a foreign boards of trade ("**FBOT**") if: (i) such Referenced Contracts settle against the price of one or more contracts listed for trading on an Exchange; and (ii) the FBOT makes such Referenced Contracts available to its members or other participants located in the U.S. through "direct access"[54] to its electronic trading and order matching system. A market participant will be required to aggregate FBOT-listed Referenced Contracts with other Referenced Contract positions in the same underlying commodity to determine its compliance with federal positions limits.

Specifically, in its review of the *CFTC Staff Position Limits Work Book* ("**Workbook**"),[55] which was issued concurrently with the Proposed Rule, the Working Group has identified several contracts listed on ICE Futures Europe ("**IFEU**")[56] that are priced-linked to the enumerated energy Core Referenced Futures Contracts ("**CRFCs**"). Recognizing IFEU's status as registered FBOT with the Commission, the Working Group is nevertheless concerned that the extension of the proposed federal position limits regime to Referenced Contracts listed for trading on IFEU could have the unintended consequences of (i) requiring U.S.-based market participants to comply with potentially conflicting requirements of multiple regulators (*i.e.*, the CFTC and Financial Conduct Authority) and position limits regimes (*i.e.*, CEA and MiFID II), and (ii) incentivizing a foreign regulator to extend its reach into CFTC jurisdictional markets. Such

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[53] *See* Proposed Rule at 11,685-686 (noting that intra-commodity spreads promote price convergence and liquidity).

[54] "Direct access" means "an explicit grant of authority by [an FBOT] to an identified member or other participant located in the United States to enter trades directly into the trade matching system of the foreign board of trade." Proposed Rule at 11,634 n.238 (citing CFTC Regulation 48.2(c)).

[55] PDF and Excel versions of the CFTC *Workbook* can be found at the following link: https://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/PositionLimitsforDerivatives/index.htm.

[56] *See In the Matter of the Application of ICE Futures Europe for registration pursuant to Section 4(b)(1) of the Commodity Exchange Act and Part 48 of the Regulations of the Commodity Futures Trading Commission in order to permit direct access to its order entry and trade matching system*, Order of Registration, Commodity Futures Trading Commission (Oct. 31, 2016).

conflicts would likely violate the principles of international comity recognized by the Commission.[57]

As noted in its recent Cross-Border NOPR, principles of international comity counsel the government in one country to act reasonably in exercising its jurisdiction with respect to activity that takes place in another country, as statutes should be construed to "avoid unreasonable interference with the sovereign authority of other nations."[58] When considering, among other things, the level of a foreign jurisdiction's supervisory interests over the subject activity and the extent to which the activity takes place within the foreign territory, the Commission has strived to minimize conflicts with the laws of other jurisdictions. In this respect, the Commission has traditionally sought to implement an approach based on substituted compliance intended to mitigate burdens associated with potentially conflicting foreign laws and regulations in light of the supervisory interests of foreign regulators in entities domiciled and operating in their own jurisdictions.

The Working Group believes that to avoid such conflicts, the Commission should pursue an approach based on substituted compliance with respect to Referenced Contracts listed on FBOTs similar to that adopted with respect to swaps under CEA Section 2(i). Such an approach would help minimize both costs and regulatory burdens imposed on market participants by having to develop systems, monitor position, and revise or create new internal risk management practices or procedures that must address competing regulatory requirements applicable to the same Referenced Contract

b. Identification of Referenced Contracts Subject to the Federal Regime.

The Working Group appreciates the time and effort of Commission staff to prepare the *Workbook*, which provides a preliminary view of Referenced Contracts listed for trading on an Exchange that would be subject to federal speculative position limits. The Working Group has carefully reviewed the *Workbook* in order to constructively comment on it. Through this process, various questions, inconsistencies, and omissions as well as instances of double counting with respect to certain Referenced Contracts have been identified. The *Workbook* should clearly explain the principles and rational used by Commission staff for determining which commodity derivative contracts are included in the *Workbook* and those that are not. Additional clarity and certainty are required before the *Workbook* is adopted or otherwise formally recognized by the Commission as being an accurate and complete listing of exchange-listed Referenced Contracts subject to federal speculative position limits.

The following provides illustrative examples of issues with the *Workbook* identified by the Working Group:

- *Crude Oil Referenced Contract Example*. In Line 50, the *Workbook* includes the IFUS Argus WTI Midland vs WTI Trade Month futures contract (MSV). However, the *Workbook* does not include the NYMEX WTI Midland (Argus) vs. WTI Trade Month futures contract (WTT), which essentially a look-alike contract. It is not clear to the Working Group why the MSV contract is identified as Referenced Contract in the *Workbook*, but the WTT contract is not included.

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[57] *See* Notice of Proposed Rulemaking, *Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants*, 85 Fed. Reg. 952, 957-58 (Jan. 8, 2020) ("**Cross-Border NOPR**").

[58] Cross-Border NOPR at 957.

- *Refined Products Referenced Contract Example*. In line 293, the *Workbook* includes NYMEX Los Angeles Jet Fuel (Platts) vs. NY Harbor ULSD Heating Oil (MQ) futures contract. However, the *Workbook* does not include IFUS LA Jet Fuel (Platts) vs Heating Oil 1st Line (LA4) futures contract. Since both contracts refer to the ULDS Heating Oil futures, it is not clear to the Working Group why the MQ was identified as a Referenced Contract in the *Workbook*, and why the LA4 contract is not included.[59]

In the interest of consistency and uniformity, the *Workbook* should be subject to a coordinated, cross-disciplinary review by the Commission, the Exchanges, and market participants. The Working Group recommends that the Commission appoint a multi-disciplinary task force subject to the supervision and guidance of the Energy and Environmental Markets Advisory Committee for purposes of working to develop a comprehensive baseline list of Referenced Contracts (*i.e.,* futures) listed for trading on the Exchanges. The task force should be comprised of DMO staff, Exchange personnel, commercial firms, and other entities who participate in markets for energy and agricultural commodities and metals.

The need for regulatory certainty with respect to the scope and applicability of the proposed federal regime to Referenced Contracts is paramount. For commodity derivatives contracts that are not listed in the *Workbook*, market participants will need to go through the subjective process of making individual determinations about whether such contracts are subject to federal position limits. The Working Group's task force proposal would help to minimize the compliance burdens imposed on market participants by the Proposed Rule and help to mitigate differing interpretations across the industry about which contracts are "in" or "out" of the federal regime.

c. <u>The Commission Should Clarify That the "Material Terms" Approach for Identifying "Economically Equivalent Swaps" Does Not Undercut Distinguishing Swaps from Futures</u>.

Proposed Regulation 150.1 defines the term "economically equivalent swap" as swaps that have "identical material contractual specifications, terms, and conditions to such referenced contracts." Subclause (1) further provides that a "swap shall not be deemed to lack identical material specification, terms, and conditions due to different . . . post-trade risk management arrangements."[60] For the limited purpose of determining whether an over-the-counter swap is an "economically equivalent swap" in the context of federal position limits, the elimination from the analysis of post-trade risk management, such as credit support arrangements, is questionable, but arguably makes practical sense. The emphasis of the Proposed Rule's analysis appears to focus on whether exposure to price movements in the underlying commodity are equivalent between the swap and the CRFC.

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[59] As discussed in Section II.B.3.c, many physical energy commodities and commodity derivatives contracts in the same underlying commodity but deliverable at different locations frequently price off the spot month CRFC.

[60] Proposed Rule at 11,717. The Working Group is not commenting or taking a position on whether any economically equivalent swap should be the subject of any necessity finding.

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Any final rule issued in this proceeding should provide guidance that disregard of post-trade risk management arrangements is specific to the analysis under the definition of "economically equivalent swaps" as that definition is set forth in proposed Regulation 150.1. Furthermore, the final rule should clarify that a significant factor in the analysis of whether any over-the-counter swap is an off-exchange futures contract is consideration of the post-trade risk management arrangements, such as differing credit support arrangements. That is, the Commission should explicitly state that when an over-the-counter swap has a return that is identical to a listed futures contract or even references such contract, the swap is not an off-exchange future if it has substantially different post-trade risk management arrangements than would otherwise be applicable to a listed futures contract.

Commercial end-user firms will often use swaps with counterparties that financially replicate futures but have different risk management arrangements. One primary reason to enter into a swap is to have collateral arrangements that are more favorable or less costly than would be available had a market participant traded futures. The regulatory uncertainty about legal characterizations of such swaps, without clarification, might have the unintended consequence of such swaps becoming unavailable, an outcome that will disproportionally affect commercial end-users. Given that the suggested course of action is legal clarification, providing such guidance is appropriate as it will help the efficient operation of the commodity derivatives markets for the benefit of commercial counterparties.

III. CONCLUSION.

The Working Group appreciates the opportunity to provide comments on the Proposed Rule and requests that the Commission consider the comments set forth herein as it develops a final rule in this proceeding. The Working Group expressly reserves the right to supplement these comments as deemed necessary and appropriate.

If you have any questions, or if we can be of further assistance, please contact the undersigned.

Respectfully submitted,
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