ISDA®
International Swaps and Derivatives Association, Inc.

SIFMA
Securities Industry and Financial Markets Association

January 11, 2011

Mr. David Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Proposed Regulations Regarding Position Limits for Derivatives

Dear Mr. Stawick:

This letter is submitted on behalf of the International Swaps and Derivatives Association, Inc.[1] ("**ISDA**") and the Securities Industry and Financial Markets Association[2] ("**SIFMA**") in response to a proposed rule currently under consideration by the Commodity Futures Trading Commission (the "**CFTC**" or the "**Commission**") establishing position limits on physical commodity derivatives (the "**Proposed Rule**"), pursuant to Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("**Dodd-Frank**"). We are pleased to follow up on the comments ISDA submitted to the CFTC in connection with the proposed rules to impose speculative position limits on referenced energy commodities (the "**January Proposed Rule**")[3] and ISDA's comments regarding the imposition of position limits under Section 4a(a)(6) of the Commodity Exchange Act ("**CEA**") on swaps that perform a significant price discovery function with respect to regulated entities.[4] We appreciate the opportunity to provide our preliminary comments on several of the concepts that we understand may be included in the Proposed Rule. While we recognize that the Proposed Rule has not formally been issued, we believe it is important that the Commission consider a number of important issues. We are therefore submitting this comment prior to the issuance of the Proposed Rule, and we respectfully urge the Commission to make significant changes to the Proposed Rule before issuing any proposed regulations to impose position limits on market participants.

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[1] ISDA, which represents participants in all aspects of the derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985, and today has over 800 member institutions from 54 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the manufacturers, governmental entities and other commercial interests that rely on listed and over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Information about ISDA and its activities is available on the Association's web site: www.isda.org.
[2] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.
[3] Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg 4143 (Jan. 26, 2010), withdrawn 75 Fed. Reg. 50950 (Aug. 18, 2010).
[4] ISDA Memorandum regarding SPDF Recommendations, November 2010. We have attached the letter to this submission.

Introduction

We understand that the Commission is required under Dodd-Frank to develop position limit requirements, "as appropriate," with respect to derivatives on physical commodities. We appreciate the careful thought and attention the Commission has given to this matter and the process through which the Commission is endeavoring to craft an appropriate position limit regime, including the withdrawal of the January Proposed Rule. We look forward to working with the CFTC in developing a position limit regime that will prevent market manipulation and disruption.

Based on the information that the Commission has made publicly available, we remain deeply concerned, however, that the proposed rules that the Commission is currently considering, are not appropriate and will not achieve the Congressionally-mandated objectives of establishing position limits that maintain sufficient market liquidity for bona fide hedgers and ensure that the price discovery function of the markets is not impaired. We believe that Section 737 of Dodd-Frank, while requiring the Commission to promulgate position limits, if appropriate, also provides the Commission with the discretion to design a position limit regime in a manner that protects and enhances the existing liquidity of such markets and provides adequate price discovery for commercial entities and other market participants. We urge the Commission to develop a Proposed Rule that reflects the necessary balance of these considerations.

Many thoughtful market commentators have noted that position limits can be a useful tool but that they can also restrict market liquidity and impair the price discovery function of the markets utilized by a broad range of market participants, particularly commercial hedgers. Therefore, the system of position limits adopted by the Commission should be carefully calibrated to balance these objectives. We believe that the focus of position limits imposed by the Commission should be to prevent an individually-controlled entity from manipulating and/or disrupting the market. Absent that ability, we do not believe that the harm position limits will cause to the liquidity and the price discovery function of the markets justifies their imposition.[5] In our view, achieving this appropriate balance requires that the Commission modify its approach in a number of respects.

Spot-Month Position Limit

First, we believe that the Commission should only impose position limits on physically-settled contracts held in the spot month. The imposition of single-month and all-months-combined limits will significantly reduce liquidity across all months of a contract, especially in the outer months. As we noted in our comment letter to the January Proposed Rules, if market participants are limited in the positions they can hold across all months, they will concentrate their holdings in contracts near the spot month. This will reduce liquidity in the outer months and increase volatility closer to expiration, thereby increasing the cost of hedging for commercial producers who are seeking to protect against long-term price risk by trading in the outer months. Moreover, we believe that position limits outside the spot month are unnecessary because the opportunity for and risk of manipulation attempts are dramatically lower.

In addition, we do not believe that the Commission should impose limits on cash-settled contracts since trading in financially-settled futures in the spot month does not affect the physical settlement price. However, if the Commission does impose position limits on cash-settled contracts, we believe that the conditional spot-month limit for cash-settled contracts should not be limited to those market participants

[5] As noted by Commissioner Scott O'Malia's closing statement at the public meeting to consider the adoption of the January Proposed Rule, "[T]he fact that the proposed position limits are modeled on the agricultural commodities position limits forces us to examine whether those agriculture limits were effective in preventing the price spikes in 2007 and 2008. Despite federal position limits, contracts such as wheat, corn, soybeans, and cotton contracts were not spared record setting price increases."

that do not have positions in physical-delivery contracts. Forward month positions and properly sized spot-month positions in the physical delivery contracts should be permitted, as such positions should not be able to be improperly used to affect price and benefit cash-settled contracts.

Further, in calculating the spot-month position limit, we encourage the Commission to use "available deliverable supply" as the basis for its determination of the actual position limits, instead of the new, undefined, and vague term "estimated deliverable supply." As the Commission has noted in prior administrative decisions, as a matter of law, "available deliverable supply" is measured over the period in which a market participant can procure a commodity with "prudent planning," and such supply includes 1) all available local supply, 2) all deliverable non-local supply, and 3) all comparable supply (based on factors such as product and location).[6] In short, available deliverable supply is supply that can be made readily available for delivery under contract terms. We believe this historical precedent provides a more accurate benchmark for setting position limits than "estimated deliverable supply." We urge that "available deliverable supply" be set and adjusted no more frequently than annually with at least 90 days advance notice to avoid market disruptions that would be caused by traders being required to adjust their positions without adequate notice.

Finally, we believe that relying on "estimated deliverable supply" as determined by reporting markets would be problematic because reporting markets have not developed a systematic or uniform process for calculating deliverable supply for all physical commodities. In addition, reporting markets historically have not made these estimates publicly available. If the Commission is to base its position limits on estimates of deliverable supply prepared by reporting markets, market participants will need a clear understanding of the deliverable supply that will be used by the CFTC to generate the position limits. Moreover, in order for this regime to be effective, the data used by the CFTC must be transparent and accessible by market participants, so that they can replicate the calculations of reporting markets and thereby anticipate the position limits and adjust their holdings to ensure orderly compliance with such limits. As we noted in our comment letter to the January Proposed Rule, we continue to urge the Commission to explain how factors such as production, storage, and/or alternate delivery options will be measured in the calculation of the estimated deliverable supply, if the Commission continues to believe that the concept of "estimated deliverable supply" is an appropriate basis for determining position limits.

In the event that the Commission does impose position limits outside the spot month, we believe that netting between the over-the-counter ("**OTC**") contracts and futures contracts is necessary to ensure consistent treatment between designated contract markets and OTC markets and to accurately reflect the true positions that market participants hold in the market. Not allowing netting between OTC contracts and futures contracts would unnecessarily impede the ability of participants in one market from utilizing the liquidity in the other, ultimately reducing liquidity in both markets and raising the costs of hedging for all market participants, including end-users. In order to facilitate netting, the Commission should ensure that the concept of "economically equivalent" derivatives covers contracts whose correlation with futures can be established through accepted models that address features such as maturity, payout structure, locational basis, product basis, etc. Therefore, we urge the Commission to ensure that any proposed rule imposing position limits outside the spot month will permit market participants to net across their positions in the futures and OTC markets.

Pass-Through of Limits to Enhance Liquidity for Market Participants

We believe the Commission should use the broad power given to it under new Section 4a(a)(7) of the CEA to allow market participants to avail themselves of the position limits that their OTC counterparties

[6] In re Cox, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) 23,786, at 34,062 – 34,065 (CFTC July 15, 1987).

might have available to them, regardless of the classification of those counterparties or the nature of their activities. Section 4a(a)(7) gives the Commission authority to exempt from any position limit rule, conditionally or unconditionally, "any person or class of persons, any swap or class of swaps, any contract of sale for future delivery or class of such contracts, any option or class of options, or any transaction or class of transactions." We believe that allowing the financial intermediary to rely on the counterparty's position limit is warranted because the intermediation function that these market participants, such as swap dealers, perform does not increase the amount of speculation in the markets; it merely transfers net risk from one execution venue to another.

While we acknowledge the Commission's efforts to allow this activity in the context of bona fide hedging, we believe it should be extended to all market activity. If any market participant remains under its position limit, a counterparty dealer should be permitted to carry the position limit (e.g. to permit futures trading) of that counterparty, up to the position limit that is applied to such counterparty. We believe that an overwhelming amount of near-term hedging activity of consumers and producers is met in the market by financial intermediaries. If swap dealers are unable to use the position limits available to both sides of the market, they will not be able to accommodate bona fide hedging or other risk management services for market participants, thus diminishing and impairing market liquidity. This will in turn raise the cost of hedging transactions utilized by end-users, limiting their ability to effectively manage their commercial and financial risks.

We also believe the Commission should use the authority granted to it under Section 4a(a)(7) of the CEA to provide a larger position limit to passive, unleveraged investment entities. We believe these market participants perform a vital role in the commodity markets, by bringing new capital and liquidity to these markets, enhancing their price discovery function, and facilitating the ability of commercial market participants to hedge their price exposures. There is no evidence that these entities engage in excessive speculation or that they affect fundamental market dynamics, and we believe their importance to the markets warrants a limited exemption from the position limits that would otherwise apply to them. In fact, because they are unleveraged, they are unlikely to have any effect on market prices and we believe onerous restrictions on these market participants will impair price discovery further out on the forward curve for many commodities, where many commercial producers hedge their financial risks. Imposing onerous position limits on passive, unleveraged investment entities will also unnecessarily constrain liquidity in the futures market for commercial users, and will increase the cost and limit the ability of end-users to hedge their commercial and financial risks.

Account Aggregation Standard

We believe the proposed exemption from the account aggregation requirements for accounts managed by independently controlled traders should also apply to financial entities that meet the criteria for the exemption. In those instances in which trading operations are completely separate from one another, and adequate procedures are in place to protect against the flow of information between them, there is no need or basis for aggregation. Under such circumstances, therefore, aggregation will serve only to restrict the ability of these entities to conduct necessary hedging and other trading activities and will actually require them to coordinate their operations, rather than keeping them separate.

As we noted in our comment letter on the January Proposed Rule, we also believe that elimination of the independent account controller exemption for financial entities is inconsistent with well-established CFTC precedent, as well as the approach taken by the SEC under the Securities Exchange Act of 1934[7]

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[7] For example, the SEC will permit the parent holding company of qualified institutional investors to disaggregate the holdings of its various business units if there are appropriate informational barriers between the business units for purposes of Section

and by the Federal Energy Regulatory Commission under Section 203 of the Federal Power Act permitting disaggregation of positions where the positions are independently controlled.[8]

While we appreciate the Commission's acceptance of an exemption in certain circumstances, we believe that all of the Commission's reasons for an independent account controller exemption for non-financial entities also apply to financial entities that operate with information barriers, separate trading strategies and other factors evidencing lack of common control. We also note that if sufficient separation exists between affiliates, there should be no concern about the affiliates trading in concert or in any coordinated manner, which is the reason for the aggregation requirements. Additionally, financial entities may have affiliates that make direct investments into third-party entities that actively participate in the commodities market. To comply with the aggregated position limit, these separate entities will now have to share competitive trading information, which may raise antitrust concerns and concerns over the fiduciary duty to protect client trading information.

Coordination with International Regulators

Lastly, we are concerned that the Commission's proposed rules will restrict activity in the U.S. while other comparable financial center jurisdictions do not impose similar constraints, creating the risk of liquidity moving away from the U.S. to these other venues. Congressional intent on this issue is clear, as Section 737 of Dodd-Frank explicitly requires the Commission to ensure that "trading on foreign boards of trade in the same commodity will be subject to comparable limits and that any limits to be imposed by the Commission will not cause price discovery in the commodity to shift to trading on the foreign boards of trade." The European Commission recently published an initial consultation document on market review that raises for consideration the general topic of position limits, although it provides no specificity on the imposition of position limits. This consultation document is the beginning step in a lengthy process that could take as long as three years to result in regulations, and there is no certainty as to the outcome. Other equally important jurisdictions have not even begun to consider position limits in a substantive way. We believe there must be international coordination on this issue, and thus we recommend that the Commission adopt position accountability levels until there is clarity that the U.S. position limit regime is commensurate with the approach being taken by other jurisdictions.

Conclusion

We believe it is possible to create a position limit regime that meets the statutory requirements of Dodd-Frank and also serves the needs of the marketplace, but, as our comments indicate, much more work and research need to be done in order to reach the appropriate balance. We recommend that studies be undertaken to examine the impact of the Commission's proposals and to consider alternative position limit regimes. We also recommend that the National Futures Association, an experienced and respected self-regulatory organization, call on the resources of its larger registrants to fund efforts to devise sensible position limit proposals that preserve market liquidity while ensuring that manipulation and excessive speculation are deterred. We respectfully urge the Commission to make significant changes to the Proposed Rule before making it available for public comment.

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13(d) and (g) and Section 16(a) reporting requirements. See Amendments to Beneficial Ownership Reporting Requirements, Exchange Act Release No. 34-39538, 63 Fed. Reg. 2854, at 2857-8 (Jan. 12, 1998).

[8] 18 C.F.R. § 33.1 (2009).

ISDA and SIFMA appreciate the opportunity to provide these comments and stand ready to provide any assistance in this process that might be helpful to the Commission. Please feel free to contact us or our staff at your earliest convenience.

Sincerely,

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November 17, 2010

Mr. David Stawick
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Washington, D.C. 20581

Re: SPDF Recommendations

The CFTC has asked for input from ISDA regarding how to determine whether a swap qualifies as performing a significant price discovery function with respect to regulated entities[1] ("SPDF") for purposes of the position limits in Section 4a(a)(6) of the Commodity Exchange Act. In deciding whether a swap performs an SPDF, Section 4a(a)(4) of the Act directs the Commission to consider price linkage, arbitrage, material price referencing, material liquidity, and other material factors that it finds relevant. We suggest that the CFTC adopt an industry-led certification process in which market participants petition the CFTC to certify categories of swaps as SPDFs. The CFTC should certify swaps as SPDFs when a petitioner provides both qualitative and quantitative factors demonstrating the similarity of the swap contract to commodities traded on regulated entities. In establishing a certification process, we recommend that the CFTC take into account the following issues:

First, the CFTC must determine how to apply position limits, including the imposition of interim aggregate position limits. Section 4a(a)(3) of the Act imposes upon the CFTC the divergent mandates to diminish excessive speculation and market manipulation while simultaneously ensuring sufficient market liquidity for bona fide hedgers and the ability of the markets to maintain their price discovery functions. Given these dual purposes, we

[1] Regulated entities are defined by § 1a(29) of the Commodity Exchange Act (the "Act") as including, among other things, designated contract markets. This definition is expanded by § 721(a)(18) of Dodd-Frank to include swap execution facilities.

recommend that the CFTC impose position limits under §§ 4a(a)(2)[2] and (5)[3] only in the spot month while the aggregate limit in § 4a(a)(6)[4] should apply to each month, all months, and the spot month. Moreover, insofar as SPDFs encompass economically equivalent swaps, we believe that it is appropriate to apply the § 4a(a)(6) aggregate limit to each month and all months while limiting the applicability of the § 4a(a)(5) limits to the spot month. Applying the general and "economically equivalent" position limits only to the spot month ensures market participants retain sufficient month-to-month and long-term flexibility in their portfolios to effectively manage risk. Due to the difficulty of imposing the § 4a(a)(6) permanent aggregate position limits on the market, we recommend that such limits be phased in. To facilitate the implementation of the permanent limits, we recommend that the CFTC impose interim aggregate position limits in the spot month until the permanent limit is phased in.

Second, the CFTC must decide which factors to consider when designating SPDFs. In determining which swaps perform SPDFs, § 4a(a)(4) directs the CFTC to consider, as appropriate, price linkage, arbitrage, material price references, material liquidity, and other material factors. We believe that a mixed qualitative and quantitative inquiry adequately addresses the § 4a(a)(4) mandate. The qualitative aspects of the inquiry should focus on the closeness of the swap to the commodity traded on regulated entities and include factors such as their substitutability and whether they are the product or byproduct of the commodity traded on the regulated entity. For the quantitative analysis, we recommend that the CFTC apply factors that reflect a concept of a "highly effective" hedge. The Financial Accounting Standards Board Statement of Financial Accounting Standards No. 133, entitled Accounting for Derivative Instruments and Hedging Activities ("FAS 133"), provides an example of a test designed to measure hedge effectiveness. Under FAS 133, a hedged commodity and its hedging instrument are entitled to hedge accounting if there is a price correlation ratio of between 80% and 125% (i.e., hedge accounting may be used if a price change in the underlying commodity is accompanied by a corresponding price movement in the hedging commodity that offsets between 80% and 125% of this change). We recommend that the CFTC look towards FAS 133 as a model of a test that it could implement, though the correlation ratios need not be identical to FAS 133 so long as there is a bright line. In addition, it should be clear that the correlation should recognize the possibility that more than a single commodity may provide the requisite level of correlation (e.g., jet fuel that correlates 50% to heating oil and 50% to crude oil should be a recognized SPDF).

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2 Section 4a(a)(2) authorizes the Commission to promulgate regulations to limit the amount of positions, other than bona fide hedge positions, that may be held by any person with respect to futures and options on future contracts in exempt or agricultural commodities traded on or subject to the rules of a designated contract market ("DCM").

3 Section 4a(a)(5) authorizes the Commission to establish position limits, including aggregate position limits, for swaps that are "economically equivalent" to DCM contracts in exempt and agricultural commodities.

4 Section 4a(a)(6) authorizes the Commission to set aggregate position limits based on the same underlying commodity, across contracts listed on DCMs, foreign boards of trade, and swap contracts that "perform or affect a significant price discovery function" with respect to regulated entities.

Third, because cross-commodity price correlation can change over time, any statistical test used in measuring hedge effectiveness should be prospective only and should be reevaluated periodically. Position limit compliance should be evaluated solely based on whether a swap was a certified SPDF at the time it was executed or a corresponding contract is subsequently executed.[5]

The fourth issue is how to approach the netting of SPDFs against other contracts. An SPDF should be able to be netted against a commodity with which it is correlated, to the extent of the correlation. In the futures markets, netting of positions is typically permitted to the extent that the positions offset one another. Because SPDF limits are premised upon a desire to apply similar regulatory standards to on-exchange and off-exchange swaps, policy indicates that netting principles applied in the futures markets ought to apply to swaps as well. To this end, we recommend that SPDFs be permitted to net against the commodities with which they correlate to the extent of their correlation for purposes of determining compliance with the aggregate position limits in § 4a(a)(6).[6]

Finally, we advocate an approach to SPDF position limits in which SPDF netting is triggered only after an entity has exceeded both its general position limit and its bona fide hedge exemption limit. This approach would use an opt-in procedure through which entities that exceed their general and bona fide hedge exemption limits are permitted to justify these excessive positions to the CFTC based upon an affirmative demonstration that these excesses would be cured by netting against their SPDFs. This approach correctly aligns incentives so that parties who rely on SPDF netting take it upon themselves to demonstrate the appropriateness of such netting. It also avoids the need for the SPDF analysis in the vast majority of situations where entities' positions are below position or hedge exemption limits.

Based on the foregoing, we recommend that the CFTC implement an approach in which market participants petition for swaps to be deemed SPDFs based upon qualitative factors as well as a statistical test measuring cross-commodity or commodities price correlation, that SPDF categories be applied prospectively rather than retrospectively, and that parties should be entitled to net SPDFs against commodities against which they are correlated, to the extent of such correlation.

Sincerely,

Conrad P. Voldstad

Conrad P. Voldstad
Chief Executive Officer

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5 In situations where the original contract that was used in calculating position limit compliance expires or terminates early a party should be permitted to enter into a new contract for which the swap acts as an SPDF in calculating compliance on a net basis.

6 For example, if jet fuel is 50% correlated to heating oil and 50% to crude oil, a 100 lot jet fuel swap can offset 50 heating oil contracts and 50 crude oil contracts.