Commodity Markets Council
1300 L St., N.W. Suite 1020
Washington, DC 20005
Tel 202-842-0400
Fax 202-789-7223
www.commoditymkts.org

January 22, 2015

Via Electronic Submission

Chris Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: **Re-Opening of Comment Period Regarding Commission Agricultural Advisory Committee Discussion of Position Limits for Derivatives (RIN 3038-AD99) and Aggregation of Positions (RIN 3038-AD82)**

Dear Mr. Kirkpatrick:

The Commodity Markets Council ("CMC") appreciates the opportunity to submit the following comments to the Commodity Futures Trading Commission (the "CFTC" or "Commission") as part of its reopening of the comment period for its proposed rules (1) establishing position limits for derivatives, and (2) amending the rules governing the aggregation of positions.[1]

Introduction

CMC is a trade association that brings together exchanges and their industry counterparts. Its members include commercial end-users which utilize the futures and swaps markets for agriculture, energy, metal and soft commodities. Its industry member firms also include regular users and members of such designated contract markets (each, a "DCM") as the Chicago Board of Trade, Chicago Mercantile Exchange, ICE Futures US, Minneapolis Grain Exchange and the New York Mercantile Exchange. They also include users of swap execution facilities (each, a "SEF"). The businesses of all CMC members depend upon the efficient and competitive functioning of the risk management products traded on DCMs, SEFs or over-the-counter ("OTC") markets. As a result, CMC is well positioned to provide a consensus view of commercial end-users on the impact of the Commission's proposed regulations on derivatives markets. Its comments, however, represent the collective view of CMC's members, including end-users, intermediaries and exchanges.

[1] *See Position Limits for Derivatives and Aggregation of Positions*, 79 Fed. Reg. 71973 (Dec. 4, 2014) (proposed rule, reopening of comment period).

CMC commends the CFTC's recent efforts to understand the effects of its proposed regime for new federal positions limits on the interests of commercial participants in the physical and financial commodity markets. Forums such as the June 19, 2014 end-user roundtable on position limits and the December 9, 2014 Agricultural Advisory Committee meeting, have been productive for such commercial participants to bring their concerns forward. CMC participated in both of these forums and it has submitted comment letters to the Commission regarding its federal position limit proposal.[2] CMC incorporates those comments with this letter. In addition attached for ease of reference is an executive summary of the key points set forth in CMC's prior comment letters.

Position Limits and Properly Functioning Markets

Though not flawless, the federal position limit regime that existed prior to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") struck an appropriate balance between market protections and flexibility that allowed commercial firms to hedge their risks and manage their commercial businesses. The Commission should be careful not to disrupt the prior balance in modifying and expanding its position limit regime and accepting new, more restrictive interpretations about *bona fide* hedges. The Commission's changes to the federal position limit regime should not constitute overly prescriptive measures that hinder the use of derivatives markets by agricultural firms to manage risks in their commercial ventures.

There are many facets to the federal position limits regime, and the Commission should be mindful how changes to one aspect of the regime might stress other parts of the regime. For example, changes to the deliverable supply determination may result in higher or lower position limits for a given contract. It will be critical for the *bona fide* hedging regime to be effective and appropriate so that firm's risk mitigation activities are not restricted by the changes in position limits as changes occur in deliverable supply determinations. CMC members are concerned that, in the Commission's attempt to revisit almost every aspect of the federal position limit regime, it will not be able to predict the consequences of so many simultaneous changes. An incremental, stepwise approach by which the Commission addresses elements of the position limit regime sequentially would be preferable. But in the absence of such an approach, the Commission ought to double its efforts to ensure its changes to the federal position limits regime do not harm the physical and financial markets for commodities.

[2] September 24, 2013 - http://www.commoditymkts.org/wp-content/uploads/2014/05/CMC-Final-Anticipatory-Hedge-9.24.13.pdf; February 10, 2014 - http://www.commoditymkts.org/wp-content/uploads/2014/05/CMC-Position-Limits-Comment-Letter-2-10-2014.pdf; July 25, 2014 - http://www.commoditymkts.org/wp-content/uploads/2014/07/CMC-PL-Roundtable-Comment-Letter-FINAL.pdf

Bona Fide Hedging

A well-formed definition of "*bona fide* hedging" is essential to the Commission maintaining a proper balance between market protections and the ability of agricultural firms to use derivatives markets in furtherance of their commercial activities. If the definition is too restrictive, it will choke off legitimate hedging activity by agricultural firms. CMC offers the following comments to avoid such an outcome.

The Commission should be mindful that examples of hedging transactions often over simplify how agricultural firms operate and manage risk in the derivatives markets (*e.g.*, one-to-one hedging of purchase contracts and sales contracts). These simple examples, while informative of the enumerated hedges, should not constitute or dictate the criteria of such enumerated hedges. Hedging is often more complex. Agricultural firms often manage risk associated with large portfolios of cash and derivative positions, and come into the derivatives markets to manage operational aspects of their business that extend beyond fixed-price risk. Accordingly, the definition of "*bona fide* hedging" must be robust enough to address the needs of such agricultural firms and not be constrained by an over-simplified analysis of hedging.

The definition of "*bona fide* hedging" must account for what agricultural firms actually do in the derivatives markets, and not be formed solely to prevent potential abuses of the *bona fide* hedging exception from position limits. This tenet is particularly true if the Commission has little evidence of abuse of an enumerated hedge exemption.[3] In the view of CMC members, the discussion of the enumerated hedges has been dominated by concerns around the prevention of any conceivable form of non-hedging activity, at the expense of the needs of commercial firms and without full recognition of how their trading corresponds to the operation of their agricultural business.

Agricultural firms use derivatives to manage the commercial business beyond mitigating fixed-price risk, and often to address reasonably anticipated obligations. Here is an example:

> A local grain elevator anticipates buying grain from a farmer who will have a crop for sale in May, but who does not want to lock in a price too early. The farmer agrees to sell to the elevator at a differential to the futures price (*e.g.,* 3 cents above the May futures price). The grain elevator might hedge its unfixed price risk with long May futures. This could be done before or after agreeing to an unfixed price purchase from the farmer. When the parties agree to decide to "fix" the price of the grain, they engage

[3] The definition of "*bona fide* hedge" establishes two categories of trades: hedging transactions and speculative transactions. Any trade that is not a bona fide hedge is a speculative trade. The mandate of the Commission in formulating and implementing the definition of "bona fide hedge" is to facilitate the use of derivatives markets by commercial firms. It is not to define speculation as expansively as possible. Thus, the Commission should start with a broad interpretation of hedging transactions that qualify for an exemption from federal position limits. Otherwise, the Commission jeopardizes thwarting risk reducing derivatives trading that is neither manipulative nor speculative through definitions or interpretations which expansively classify such trades as "speculative." This result is not in furtherance of any goal related to position limits.

> in an exchange for physical transaction in which the elevator accepts a short May futures position that offsets its hedge.
>
> That same grain elevator also anticipates selling grain in July based on a differential to the futures price (*e.g.,* 5 cents above the July futures price). The grain elevator would hedge the July sale with short July futures. When the elevator and a purchaser decide to "fix" the price of the grain, they enter into an exchange for physical transaction, resulting in the elevator accepting a long futures position that offsets its hedge.

In this example, the elevator uses futures to facilitate its business of accumulating commodities today and for the later sale of those commodities. Yet, if the purchase and sales contracts are priced to index, the elevator is not hedging fixed-price risk as described under the proposed position limits rule. More accurately, it is managing a timing difference between receiving July contracts for commodities for which it will deliver May contracts. Moreover, the elevator may have a reasonable anticipation of volumes over more than one sales contract. It would be unduly burdensome if the elevator had to manage risk associated only with actual sales, and more logical to permit the elevator to manage risk associated with its anticipated sales. The logical futures trade to address this aggregate commercial activity is the calendar spread, but under the proposed definition in CFTC Regulation 150.1, using derivatives to hedge anticipated unfixed-price risk would not count as *bona fide* hedges.

Finally, the Commission should note a shift in recent years of the understanding of *bona fide* hedging by it and the staff of the CFTC (particularly the Division of Market Oversight). In the experience of CMC's members, the interpretation and construction of *bona fide* hedging has narrowed, with a formalistic emphasis on fixed-price risk and a narrower view of anticipatory hedging. CMC members would disagree with those who argue such formalism has always been the accepted interpretation of *bona fide* hedging, or that it is the only permissible interpretation. Rather, this formalism represents a change, and one that creates an overly prescriptive definition of *bona fide* hedging. There is also no convincing support for the proposition that the enactment of the Dodd-Frank Act mandated such an interpretational shift. As a result of this shift, many types of trading in derivatives markets that were long recognized as legitimate hedging by commercial firms and regulators are now no longer afforded *bona fide* hedging treatment.

Congress did not limit the Commission to recognizing only fixed-price risk as the basis for *bona fide* hedging. CMC urges the Commission to style a definition of "*bona fide* hedging" that includes other commercial risks, such as anticipated merchandising risk, risk associated with index-priced physical sale contracts, absolute price risk, spread risk, quality risk, basis risk, and execution risk (including freight and potentially foreign exchange rates) among others. CMC submits it was not Congress's intent to hurt commercial hedgers or prohibit legitimate commercial hedging activity in its attempt to prevent excessive speculation. Accordingly, the Commission should adopt a more reasonable and pragmatic approach to defining hedging.

Recognition of Risk

Firms have pricing risk when they submit an irrevocable bid or offer for a physical transaction because they incur an enforceable obligation. This recognition of risk incurred is consistent with law and modern risk management practices. The Uniform Commercial Code supports the recognition of risk upon the making of an irrevocable bid or offer. UCC Section 2-205, "Firm Offers," makes clear that a merchant is legally bound by the terms of the offer for the time stated in the offer until it is revoked or for a reasonable time, depending on the circumstances.[4] Thus, the Commission should consider hedging of binding bids and offers as a *bona fide* hedge.

Non-enumerated Hedges

The Commission, in issuing a final rule on federal position limits, should address the many concerns about the definition of "*bona fide* hedging" already placed before it by CMC and many other market participants. More specifically, the CFTC should retain its current framework for granting exemptions for enumerated and non-enumerated hedging positions. Under the proposed position limits rule, the process for market participants to apply for non-enumerated hedges may prove untimely and cause uncertainty for market participants wishing to place a hedge in dynamic commodity markets.

Aggregation

The Commission should focus solely on aggregation when a parent entity has control of day to day hedging and trading strategies of the child entity. In the instance of a firm acting on its own behalf without the control of a parent company we believe no aggregation should occur. Monitoring aggregation under the Commission's current proposal would present significant operational challenges. Many firms that would be required to aggregate positions with affiliates do not maintain centralized systems of record keeping, nor do they hedge the same type of risk. Moreover, monitoring by both Swap Dealers and FCMs would require not only additional compliance staffing, but also a robust industry tracking system. There are concerns regarding the robustness of current technological compliance solutions. Before rules are finalized, a system acceptable to the industry should be further vetted and approved to facilitate compliance. CMC's views on aggregation are more fully explained in its prior comment letters and in the attached executive summary.

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[4] Whether a bid or offer is enforceable against the maker is not determined by whether the bid or offer is in writing. *See, e.g.*¸ Scoular Co. v. Denney, 151 P.3d 615 (Co. Ct. App. 2006) (a firm offer in the grain industry "refers to a standing offer by a producer to sell a set amount of bushels, at a set price, for a set delivery date [and] [c]onsistent with ordinary common law contract principles and . . .2-205, this type of oral offer remains open and viable until the producer revokes it"); *see also* In re Grain Land Coop Cases, 978 F. Supp. 1267, 1279 (D. Minn. 1997) (grain contracts "fall squarely within the purview of the U.C.C.").

Conclusion

Thank you for the opportunity to provide comments on the commercial impacts of these rulemakings. If you have any questions or concerns regarding this letter, please do not hesitate to contact Kevin Batteh at Kevin.Batteh@Commoditymkts.org.

Sincerely,

Kevin K. Batteh
General Counsel
Commodity Markets Council