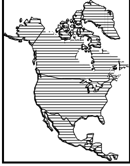

Industrial Energy Consumers of America
The Voice of the Industrial Energy Consumers

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April 21, 2010

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Re: Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations (Federal Register / Vol. 75, No. 16 / Tuesday, January 26, 2010 / Proposed Rules / pages 4144-4172

The Industrial Energy Consumers of America (IECA) is pleased to submit this letter to the Commodity Futures Trading Commission (CFTC) on its proposal to implement speculative position limits for futures and option contracts in certain energy commodities. IECA supports the adoption of speculative position limits for energy contracts. However, the proposed speculative position limits are too large and by themselves are not a solution to excessive speculation. Reducing the total volume of speculative positions relative to bonafide hedger positions is the only way to reduce excessive speculation. We urge the CFTC to take action to reduce total speculative volumes and bar speculative exemptions. As proposed, the speculative position limits will only help prevent market manipulation.

It is very important for the CFTC to clearly distinguish the differences between the two types of speculators. There is the traditional speculator that has an important role to play so long as their volumes do not become too large. The second type, the passive speculators have no positive role and whose presence decreases liquidity and significantly and negatively impacts price discovery.

IECA is a nonpartisan association of leading manufacturing companies with $800 billion in annual sales and with more than 750,000 employees nationwide. It is an organization created to promote the interests of manufacturing companies through research, advocacy, and collaboration for which the availability, use and cost of energy, power or feedstock play a significant role in their ability to compete in domestic and world markets.

Natural gas is a vital fuel and feedstock for the manufacturing sector and its price often determines whether energy intensive industry is globally competitive and whether we create or lose jobs. Natural gas is also important in determining the price of electricity because natural gas fired power generation often sets the marginal price for electricity in a growing portion of the country. This means that if the price of natural gas goes up, so will the price of electricity.

The futures market is special and unlike any other. It was created to serve the needs of buyers and sellers of consumable commodities and the managing of financial risk associated with these transactions. It is different and special because it trades a consumable product and the price of the commodity, by design, reflects the underlying supply and demand of the product.

Prior to year 2000, these markets worked well with prices reflecting the underlying supply versus demand of the physical natural gas market. Since then, the volume traded by speculators, especially passive speculators, has increased so significantly that it negatively impacts price discovery and has transformed this market from a "commodity" to an "asset" class investment. Does this make a difference to the quality of life of homeowners and farmers and the viability of manufacturers? Absolutely!

As an asset class investment, the retail investor doesn't really care about the supply or demand of the underlying commodity. Their priority is that they have made an investment in an area that diversifies their investment assets. And, when they invest in these passive index funds, the fund rolls the current month position to the next month without any regard to the price of the commodity. They are completely insensitive to price. The problem that this creates is that while we do not rely upon stocks and bonds and other asset class investments to feed our kids and run your factories – we do with energy and food commodities.

The distinction could not be greater. A well functioning market whose price reflects the supply and demand of the commodity is critical. Consumers like ourselves "must" buy and depend upon this market for our livelihood to competitively produce the products that our customers require. We are connected and completely dependent upon this market and treating the commodity market as an investment asset class is a significant deterrent to a well functioning market.

Unfortunately, the contract position volumes of the traditional and passive speculators have grown so large relative to the total size of the market and the positions volume of bonafide hedgers that the price discovery of the underlying commodity is threatened.

For illustration, in 1998, physical hedgers represented 77 percent of the market, traditional speculators were 16 percent and index speculators were 7 percent. In 2008, physical hedgers were only 31 percent, while traditional speculators rose

to 28 percent and index speculators rose to 41 percent of the total.[1] This trend is unsustainable and it is for this reason we are very supportive and appreciative that the CFTC has taken this initiative to set position limits.

We need speculative position limits, imposed by the CFTC in all consumable commodity derivates markets that will significantly reduce speculator dominance. The CFTC has a responsibility to police the commodities futures markets for fraud, manipulation and excessive speculation. Previous Commissions have shirked this responsibility and all consumers have suffered as a result. The commission should not delay in doing its job and fulfilling its current responsibility based on the hope or expectation that its responsibility will change in the future.

Comment 1. The Commission should reduce the proposed speculative position limit <u>and</u> also reduce the total volume of speculative positions relative to bonafide hedger positions

The proposed rule will only serve to reduce the threat of market manipulation, not excessive speculation. Setting a speculative position limit only prevents speculators from getting so large that they could manipulate the market. While this is a very good thing, consumers need the CFTC to also act to reduce excessive speculation. We strongly urge the CFTC to modify its position limit formula to limit speculative positions relative to that of bonafide hedgers in order to reduce excessive speculation.

Speculators volumes for natural gas should be limited to 25 percent of the market which would provide sufficient liquidity and ensure that physical producers and consumers will dominate the price discovery function. As noted above, in 1998, traditional and index speculators' volumes represented a total of 23 percent of the market and the market functioned effectively.

To reduce excessive speculation, the CFTC must reduce the volume of speculative positions and especially, ban passive speculators.

Comment 2. It is absolutely essential that passive speculators be banned from the futures market.

Today, passive speculators outnumber physical hedgers and traditional speculators and account for the largest share of speculative open interest in natural gas and it continues to grow at high rates.

As mentioned above, we encourage the Commission to distinguish the difference between the traditional speculator and the passive speculator. Of the two, the passive speculator is the worse.

Active traditional speculators add beneficial liquidity to the market by selling and buying with the objective of creating a profit. This is constructive until they

[1] Source: CFTC, Goldman Sachs, Standard & Poors, Dow Jones, calculations based upon CFTC CIT report.

control substantial volumes that damage price discovery. Passive speculators reduce liquidity by buying and then holding larger and larger quantities of futures contracts. They act as consumers who never take delivery of the commodity so the volumes continue to pile up. Their volumes are moved forward to the next month, every month, getting theoretically larger and larger. This is completely inconsistent with the functioning of a futures market that serves "consumable" commodities that have a prompt month that expires.

The objective of the passive investor is also inconsistent with a consumable futures product. We use it for price determination which impacts our profitability and our viability; they use it to diversify an asset class portfolio.

They do not care what the price of the underlying commodity is, we do. They buy regardless of whatever the price is. If the price goes up, they buy. If the price goes down, they buy. This means that their growing volumes of commodity purchases, without regard to supply and demand will impact the price that "we" and every homeowner and farmer will pay. If the American public fully understood how these passive speculative funds impact the cost of heating and cooling their homes, driving their cars and feeding their families, they would be outraged.

Passive commodity funds also publically communicate when they will roll their positions from the current month to the following month. Funds like the United States Natural Gas Fund (UNG), post the days that they will roll their positions from one month to another on their website. This is something that no producer, consumer or traditional speculator would do. Again, that is not how the futures market was created to work and damages price discovery.

Passive speculators must be banned. They will not go away without action by Commission. We strongly urge the CFTC to address this issue because without it, the price discovery function will not function as intended.

Comment 3. If you cannot or will not ban passive speculators, make them subject to the speculative position limit of a single person

Because passive index funds that include a basket of commodities and or single commodity passive funds like the United States Natural Gas Fund (USG) all predictably roll their futures positions forward in the exact same manner each month, should be subject to the position limit of a single person. Collectively, these funds outsize all other market participants, and as a result, can have market power.

The Commodity Exchange Act (CEA) says that "such limits upon positions and trading shall apply to positions held by, and trading done by, two or more persons acting pursuant to an expressed or implied agreement or understanding, the same as if the position were held by, or the trading were done by, a single person." It appears to us that this CEA provision applies to passive funds.

These funds all have written publically available documentation that describes the fund's methodology.

The CFTC appears to already have the authority to take action to prevent a single speculator or class of speculators from damaging these markets. We urge you to do so.

Specific responses to requests for comment

1. Are Federal speculative position limits for energy contracts traded on reporting markets necessary to "diminish, eliminate, or prevent" the burdens on interstate commerce that may result from position concentrations in such contracts?

Federal speculative positions limits are necessary for all energy derivatives traded on all markets including (over-the-counter markets) for two purposes: to mitigate the threat of manipulation and to reduce, eliminate or prevent excessive speculation. The Commodity Exchange Act makes it clear that the CFTC must take steps to protect the markets and the price discovery function from both manipulation and excessive speculation.

2. Are there methods other than Federal speculative position limits that should be utilized to diminish, eliminate, or prevent such burdens?

For reducing manipulation there are additional methods that could be used such as 'accountability' limits and monitoring of positions and trading by the exchanges. For reducing or eliminating or preventing excessive speculation, margin requirements could be raised for speculators but that is not as effective as setting severely reduced speculative position limits.

3. How should the Commission evaluate the potential effect of federal speculative position limits on the liquidity, market efficiency and price discovery capabilities of referenced energy contracts in determining whether to establish position limits for such contracts?

The Congress clearly recognized the inherent threat of excessive speculation because they created the CFTC and gave you the responsibility to diminish, eliminate and prevent excessive speculation.

The first step is to focus on the real customers of this market, the consumers and producers of the commodity, that is, bonafide hedgers. Whatever action the CFTC takes should strengthen their ability to trade at a low cost and at prices that reflect the physical supply and demand of the commodity. Focus on ensuring price discovery that is determined by buyers and sellers, not speculators speculating with speculators, which is where we are today.

The traditional speculator plays an important role to provide liquidity. But markets do not need excessive liquidity. A balance between the volumes of bonafide hedgers versus that of the speculator is needed. We believe that speculator volumes should be limited to under 25 percent which is what we had prior to year 2000 when the market worked well.

There is a diminishing return for marginal increases in speculative liquidity. Once there is sufficient speculative liquidity to accommodate the buying and selling of bona fide physical hedgers, then the markets do not benefit from marginal increases in speculative liquidity. In fact, from that point on, every marginal increase in liquidity works against price discovery and causes excessive speculation because more and more speculative volume is going after a relatively flat and stable volume of physical commodity. This is how volatile price spikes and bubbles are created with price rising or falling erratically.

The CFTC should act to significantly bring down speculative position limits to achieve the noted 25 percent speculative level and continually monitor the market results. If there is a lack of liquidity, it will become readily apparent to consumers and producers and the CFTC should take corrective action. As consumers, we have had lots of examples of excessive speculation over the last several years and zero problems with liquidity.

Since they reduce liquidity, and if the CFTC adopts speculative position limits that do not differentiate between traditional and passive speculators, lowering position limits could have the effect of reducing more traditional speculators than passive speculators and it could result in a significant undesirable market problem.

4. Under the class approach to grouping contracts as discussed herein, how should contracts that do not cash settle to the price of a single contract, but settle to the average price of a subgroup of contracts within a class be treated during the spot month for the purposes of enforcing the proposed speculative position limits?

No comments.

5. Under proposed regulation 151.2(b)(1)(i), the Commission would establish an all-months-combined aggregate position limit equal to 10% of the average combined futures and option contract open interest aggregated across all reporting markets for the most recent calendar year up to 25,000 contracts, with a marginal increase of 2.5% of open interest thereafter. As an alternative to this approach to an all months-combined aggregate position limit, the Commission requests comment on whether an additional increment with a marginal increase larger than 2.5% would be adequate to prevent excessive speculation in the referenced energy contracts. An additional increment would permit traders to hold larger positions relative to total open positions in the referenced energy

contracts, in comparison to the proposed formula. For example, the Commission could fix the all-months combined aggregate position limit at 10% of the prior year's average open interest up to 25,000 contracts, with a marginal increase of 5% up to 300,000 contracts and a marginal increase of 2.5% thereafter. Assuming the prior year's average open interest equaled 300,000 contracts, all-months combined aggregate position limit would be fixed at 9,400 contracts under the proposed rule and 16,300 contracts under the alternative.

We do not believe that the formulas mentioned will prevent the threat of excessive speculation. We do believe they are a constructive solution to preventing market manipulation or market power. It is really important that the CFTC provide different solutions to these two problems.

A formula based on open interest that does not account for the relative volume between speculative versus bonafide hedger positions will be ineffective at preventing excessive speculation.

The proposed limits are so large that they will only impact the very large traders and will only marginally limit their volumes. Based upon the CFTC data, this may only include the top ten traders. The proposed position limits will prevent the big speculators from getting bigger and causing market manipulation or market power.

*6. Should customary position sizes held by speculative traders be a factor in moderating the limit levels proposed by the Commission? In this connection, the Commission notes that current regulation 150.5(c) states contract markets may adjust their speculative limit levels "based on position sizes customarily held by speculative traders on the contract market, which shall not be extraordinarily large relative to total open positions in the contract ***"*

As mentioned above, the proposed CFTC formula will be instrumental in preventing market manipulation and market power but not excessive speculation. Yes, the position limits should be adjusted after implementation.

To seriously address excessive speculation, the CFTC should reduce the speculative position limits to 10,000 contracts and carefully monitor the market for its effectiveness and gradually reduce it to 5,000 contracts. It is important to monitor the market's liquidity, volatility and levels of excessive speculation.

7. Reporting markets that list referenced energy contracts, as defined by the proposed regulations, would continue to be responsible for maintaining their own position limits (so long as they are not higher than the limits fixed by the Commission) or position accountability rules. The Commission seeks comment on whether it should issue acceptable practices that adopt formal guidelines and procedures for implementing position accountability rules.

Yes, the CFTC should issue clear acceptable practices that adopt formal guidelines and procedures for implementing position accountability rules with the exchanges. Accountability limits are the responsibility of the exchange and serve to reduce the threat of market manipulation, not excessive speculation.

The CFTC has the responsibility to set hard limits for the exchanges to abide by. We believe that it is in the best interests of the exchanges to prevent market manipulation. However, as mentioned before, position limits for each commodity contract and limits for the exchanges will not prevent excessive speculation. In fact, we are of the belief that the exchanges benefit by excessive speculation because higher traded volumes increase exchange revenue. Exchanges do NOT care what happens to the price of a commodity.

8. Proposed regulation 151.3(a) (2) would establish a swap dealer risk management exemption whereby swap dealers would be granted a position limit exemption for positions that are held to offset risks associated with customer initiated swap agreements that are linked to a referenced energy contract but that do not qualify as bona fide hedge positions. The swap dealer risk management exemption would be capped at twice the size of any otherwise applicable all-months combined or single non-spot-month position limit. The Commission seeks comment on any alternatives to this proposed approach. The Commission seeks particular comment on the feasibility of a "look-through" exemption for swap dealers such that dealers would receive exemptions for positions offsetting risks resulting from swap agreements opposite counterparties who would have been entitled to a hedge exemption if they had hedged their exposure directly in the futures markets. How viable is such an approach given the Commission's lack of regulatory authority over the OTC swap markets?

An effective regulatory regime must "look through" the swap dealers to the ultimate counterparty in order to effectively apply aggregate speculative position limits which are necessary to prevent excessive speculation. Swap dealers speculating for their own account or by managing an unbalanced swaps book must face speculative position limits just like all other speculators.

One way to address this is to require that all non-bonafide hedger derivatives clear through a Derivatives Clearing Organization (DCO) so that the DCO becomes the counterparty to both sides of the trade. In this way, every OTC position can be seen by the regulators.

If a swaps entity wants to exceed aggregate speculative position limits, it must agree to the following two conditions as part of their exemption.

1. They must agree that all of their counterparties / clients will fill out Form 40 with the CFTC declaring under penalty of law what category of trader they are. The CFTC will issue their counterparties / clients a Large Trader Identification Number (LTIN).

2. The must agree to report to the CFTC on a daily basis:
   a. A list, by LTIN of all traders with futures-equivalent positions that exceed the limit for Reportable positions.
   b. An aggregate amount of all remaining futures equivalent positions that distinguish between counterparty / client positions and proprietary trading positions. This aggregate amount should not exceed aggregate speculative position limits.

9. Proposed regulation 20.02 would require swap dealers to file with the Commission certain information in connection with their risk management exemptions to ensure that the Commission can adequately asses their need for an exemption. The Commission invites comment on whether these requirements are sufficient. In the alternative, should the Commission limit these filing requirements, and instead rely upon its regulation 18.05 special call authority to assess the merit of swap dealer risk management exemption requests?

Today, the penalty for a swap dealer providing inaccurate data to the CFTC in response to a special call is not a serious problem for them. So, no, the CFTC should not rely upon its special call authority. This does not work well.

A much better solution is to make the risk management exemption from position limits, conditional upon the receipt of the necessary information from the swaps dealer. If the swaps dealer is determined to have provided inaccurate data to the CFTC, it can revoke the swaps dealer's exemption from position limits. This approach has teeth.

10. The Commission's proposed part 151 regulation for referenced energy contracts would set forth a comprehensive regime of position limit, exemption and aggregation requirements that would operate separately from the current position limit, exemption and aggregation requirements for agricultural contracts set forth in part 150 of the Commissions' regulations. While proposed part 151 borrows many features of part 150, there are notable distinctions between the two, including their methods of position limit calculation and treatment of positions held by swap dealers. The Commission seeks comment on what, if any, of the distinctive features of the position limit framework proposed herein, such as aggregate position limits and the swap dealer limited risk management exemption, should be applied to the agricultural commodities listed in part 150 of the Commission's regulations.

In our view, there is no need to change anything about the current rule for agriculture commodities. We have companies that are large buyers of agricultural commodities in our organization and they believe those commodities also suffer from excessive speculation and support reducing the speculative positions, and especially passive speculators.

11. The Commission is considering establishing speculative position limits for contracts based on other physical commodities with finite supply such as precious metal and soft agricultural commodity contracts. The Commission invites comment on which aspects of the current speculative position limit framework for the agricultural commodity contracts and the framework proposed herein for the major energy commodity contracts (such as proposed position limits based on a percentage of open interest and the proposed exemptions from the speculative position limits) are most relevant to contracts based on other physical commodities with finite supply such as precious metal and soft agricultural commodity contracts.

No comments.

12. As discussed previously, the Commission has followed a policy since 2008 of conditioning FBOT no-action relief on the requirement that FBOTs with contracts that link to CFTC regulated contracts have position limits that are comparable to the position limits applicable to CFTC-regulated contracts. If the Commission adopts the proposed rulemaking, should it continue, or modify in any way, this policy to address FBOT contracts that would be linked to any referenced energy contract as defined by the proposed regulation?

We do not believe there would need to be a change in policy.

13. The Commission notes that Congress is currently considering legislation that would revise the Commission's section 4a (a) position limit authority to extend beyond positions in reporting market contracts to reach positions in OTC derivative instruments and FBOT contracts. Under some of these revisions, the Commissions would be authorized to set limits for positions held in OTC derivative instruments and FBOT contracts. The Commission seeks comment on how it should take this pending legislation into account in proposing Federal speculative position limits.

The CFTC has the responsibility to prevent manipulation and excessive speculation and it should not delay taking action regardless of Congressional action.

14. Under proposed regulation 151.2, the Commission would set spot-month and all-months-combined position limits annually.

> *a. Should spot-month position limits be set on a more frequent basis given the potential for disruptions in deliverable supplies for referenced energy contracts?*

The CFTC should review the need to change the spot month position limits annually. It should also maintain the flexibility to address changes to the spot month limits on an "as needed basis" in the event of market disruptions.

b. Should the Commission establish, by using a rolling-average of open interest instead of a simple average for example, all-months-combined position limits on a more frequent basis? If so, what reasons support such action?

The proposed position limits will not reduce excessive speculation. We do not believe that a rolling average will make any difference in reducing excessive speculation.

15. Concerns have been raised about the impact of large, passive, and unleveraged long-only positions in the futures markets. Instead of using the futures markets for risk transference, traders that own such positions treat commodity futures contracts as distinct assets that can be held for an appreciable duration. This notice of rulemaking does not propose regulations that would categorize such positions for the purpose of applying different regulatory standards. Rather, the owners of such positions are treated as other investors that would be subject to the proposed speculative position limits.

a. Should the Commission propose regulations to limit the positions of passive long traders?

Yes, it is absolutely critical that passive funds (long-only) (short only) positions on the futures market be banned because they reduce liquidity and damage price discovery. There is nothing that the CFTC can do that is more important to reduce excessive speculation than to ban participation by these funds. It is urgent that the CFTC address this. The passive funds positions are already substantially larger than that of physical hedgers and continue to grow.

b. If so, what criteria should the Commission employ to identify and define such traders and positions?

The CFTC should devise a menu of qualifications that if an entity meets any one of the following, it would be prohibited from participating in the futures market.

The list could include: the entity and the entity's customers must have the ability to take delivery of the physical product; the entity cannot roll its positions from month to month on the same days each month or publically communicate the days that it is rolling its position; the entity cannot have the stated intention to "invest" for the "long term"; the entity cannot offer "long only" or "short only" products to the investor; the entity cannot have a buying or selling position that is unidirectional 90 percent of the time.

c. Assuming that passive long traders can properly be identified and defined, how and to what extent should the Commission limit their participation in the futures market?

Passive long or passive short speculative traders should be banned. If not banned, their volume of positions should be severely limited to no more than 5 percent of total open interest.

> *d. If passive long positions should be limited in the aggregate, would it be feasible for the Commission to apportion market space amongst various traders that wish to establish passive long positions?*

Passive speculative traders should be banned.

> *e. What unintended consequences are likely to result from the Commission's implementation of passive long position limits?*

Banning or severely restricting such funds would reduce excessive speculation; increase the liquidity; and improve price discovery so that prices will better reflect the supply and demand of the underlying commodity.

16. The proposed definition of referenced energy contract, diversified commodity index, and contracts of the same class are intended to be simple definitions that readily identify the affected contracts through an objective and administerial process without relying on the Commission's exercise of discretion

> *a. Is the proposed definition of contracts of the same class for spot and non-spot months sufficiently inclusive?*
> *b. Is it appropriate to define contracts of the same class during spot months to only include contracts that expire on the same day?*

No comments.

17. Under the proposed regulations, a swap dealer seeking a risk management exemption would apply directly to the Commission for the exemption. Should such exemptions be processed by the reporting markets as would be the case for bona fide hedge exemptions under the proposed regulations?

No. It is important that the swaps dealers report directly to the CFTC monthly and such reports should clearly illustrate what their positions are.

18. In implementing initial spot month speculative position limits, if the notice of proposed rulemaking is finalized, should the Commission:

> *a. Issue special calls for information to the reporting markets to assess the size of a contract's deliverable supply;*
> *b. Use the levels that are currently used by the exchanges; or*
> *c. Undertake an independent calculation of deliverable supply without substantial reliance on exchange estimates?*

No comments.