January 17, 2012

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: Position Limits for Futures and Swaps
(CFTC RIN 3038-AD17)

Dear Mr. Stawick:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned Interim Final Rule (the "Interim Final Rule") published by the Commodity Futures Trading Commission ("CFTC") on November 18th 2011, the purpose of which is to establish position limits for certain physical commodity derivatives, as required by and pursuant to provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("the Dodd-Frank Act").[2]

INTRODUCTION

In the Interim Final Rule, the CFTC requests input on the proposed spot month position limits, along with any alternative ratios.[3] The CFTC recognizes a complex set of incentives that may encourage manipulative behavior, and seeks to "[diminish] the incentive to exert market power to manipulate the cash-settlement price or index."[4] The question is asked whether the Interim Final Rule maximizes the objectives it is intended to achieve: (1) The protection of market participants and the public; (2) the efficiency, competitiveness, and financial integrity of the futures markets; (3) the market's price discovery functions; (4) sound risk management practices; and (5) other public interest considerations.[5]

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1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

2 While this letter responds specifically to the questions posed in the Interim Final Rule, it builds upon the information contained in the comment letter filed by Better Markets on March 28, 2011, which is incorporated hereby as if fully set forth herein. *See* Better Markets, "Position Limits for Derivatives," March 28th 2011 ("March 28 Position Limits Letter"), *available at* http://bettermarkets.com/rulemaking/better-markets-comment-letter-position-limits

3 Federal Register/Vol. 76, No. 223/Friday, November 18, 2011/Rules and Regulations, pp71637-8

4 *Ibid.*

5 Op. Cit. 71638

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DISCUSSION

The issue of spot month limits has several layers of complexity, but clarity can be achieved by bearing in mind the fundamental reason for position limits. They are mandated in the Dodd-Frank Act to protect against both manipulation and against excessive speculation.[6] In the context of spot month limits, the immediate danger is, of course, manipulation, given the interplay between the physical market, the physical-settled derivatives market, and the cash-settled derivatives market, in which settlement is generally made against the settlement prices of physical-settled derivatives contracts.

It is generally recognized that if a single trader could amass a large, leveraged position in a cash-settled lookalike contract, he would have a strong incentive to manipulate the price of the physical-settled contract against which the lookalike is settled. Indeed, this is a classic manipulation scenario: a leveraged position that is settled against the price of an unleveraged underlying ("Classic Manipulation Scenario"). Such a scenario encourages manipulative behavior in which a trader amasses a large leveraged position in the cash-settled contract, and then "bangs the close" in the physical-settled contract to raise (or lower) the reference price against which the cash-settled contract will be evaluated.

While there are other forms of manipulation that do not require this structure (e.g. it can be profitable to corner a market by quickly buying a physical commodity and then slowly selling it back into the now artificially scarce market), the Classic Manipulation Scenario is particularly important to avoid, because of its unique temptations for market participants, and the fact that it is harder to identify. Such manipulation is often both less risky (in can even look rather like "arbitrage" in some cases) and less visible (it does not require the taking possession and storage of large quantities of physical product) than a classic squeeze. Therefore, to prevent such activity, the CFTC must act prophylactically by imposing strong position limits *ex ante* rather than relying on identifying such activity *ex post.*[7]

Better Markets understands that the above scenario was the primary rationale behind the CFTC's original concept of "conditional" spot month limits, in which the markets for physical-settled and cash-settled contracts are insulated from one another during the spot month period. Under the original proposal, a baseline position limit would be set for the physical-settled contract, based on estimated deliverable supply.[8] A trader in lookalike contracts could have up to 5X the baseline position limit so long as he did not also trade physical-settled contracts. Thus, he could continue to provide liquidity in the cash-settled market without being able to manipulate the physical-settled market. Should he begin to trade spot month physical-settled contracts, he would have to liquidate his cash-settled position until it fell below 1X the baseline position limit. Therefore, any trader who traded physical-settled contracts would not be able to amass a leveraged cash-settled position, and

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6 Dodd-Frank Act § 737(A)(4), 7 U.S.C. § 6a(A)(3)(B).

7 There are separate provisions in Dodd-Frank relating to disruptive trading practices (Dodd-Frank Act § 747). Some have used this fact to argue that position limits on cash-settled contracts are unnecessary. However, the five objectives enumerated above can only be satisfied with both regimes acting in tandem: *ex ante* position limits to deter manipulative behavior, and *ex post* identification and investigations when such behavior does indeed occur. A synchronized approach like this would achieve the greatest benefit for the least cost. *See also* Better Markets, "Comment Letter on Antidisruptive Practices Authority," January 3rd 2011 (http://bettermarkets.com/sites/default/files/CFTC-%20Comment%20Letter-%20Antidisruptive%20Practices%20%201-3-11.pdf)

8 Federal Register/Vol. 76, No. 223/Friday, November 18, 2011/Rules and Regulations, pp71634-7

any trader with a leveraged cash-settled position would be unable to manipulate the benchmark price so as to profit from his leveraged position. The conditional limits originally proposed would therefore have ruled out the Classic Manipulation Scenario.

In the Interim Final Rule, the CFTC has abandoned the concept of conditional rules. In its place, it has devised a two-tiered system, in which all commodities other than natural gas have a firm limit in both physical-settled and cash-settled contracts of 1X the baseline limit. As a result, a trader may hold contracts equivalent to 50 percent of deliverable supply. However, because the cash-settled portion of the position cannot be highly leveraged, the incentive for manipulation of the physical-settled contract is relatively small, since any profits reaped from the cash-settled position would be somewhat offset by the expense of bumping up (or down) the physical-settled price at the relevant settlement window. The Classic Manipulation Scenario is therefore severely curtailed if not entirely prevented.

In the case of natural gas, however, the spot month limit in the cash-settled contract is set in the Interim Final Rule at 5X the baseline limit. The conditionality clause is removed, so that the trader may also hold physical-settled contracts.[9] Therefore, the Classic Manipulation Scenario can still arise, and the carve-out for natural gas appears inconsistent with the purposes of the Interim Final Rule. By setting up the conditions for a Classic Manipulation Scenario, the Interim Final Rule would endanger market participants and the public by exposing them to the risk of manipulation. This would have obvious negative effects on the financial integrity and efficiency of the markets, and would hamper the price formation process in the spot month, thereby defeating the very objectives set by the Interim Final Rule.

The only possible reason for such an inconsistency would be if the natural gas market is somehow less prone to manipulation than other commodities under the Classic Manipulation Scenario. However, there is no evidence that this is the case. Data submitted by the CME in connection with the original proposed rule is discussed in the Notice.[10] It appears to show that liquidity in the physical-settled natural gas CME contract **increased** when a 5X limit was introduced for the cash-settled natural gas ICE contract. However, this was under a **conditional limits** regime which, as discussed above, removes the Classic Manipulation Scenario by insulating the cash-settled and physical-settled markets during the spot month. Under the Interim Final Rule, the conditionality clause would **not** hold. Therefore, there is **no** reason to believe that the CME's liquidity findings would still hold true. Indeed, by allowing a 5X limit in cash-settled natural gas contracts without a conditionality clause, it is logical to believe that the CFTC will inadvertently **incentivize** illegal manipulative behavior, in direct violation of the primary objectives listed above.

Note that relative trading volumes are irrelevant to this question. The fact that the cash-settled market in natural gas is relatively large does not change the fact that a leveraged trader in the cash-settled market could "bang the close" in the physical-settled market, and thereby profit on his cash-settled position, which under the 5X rule could be several times larger than his physical-settled position (so the profits on the cash-settled position would far outweigh any loss incurred on the physical-settled position). Whether the cash-settled contract is thinly traded or highly liquid makes no difference as to whether or not a trader can "bang the close" in the physical-settled market.

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[9] There is also a clause that the combined cash-settled and physical-settled position cannot exceed 5X the baseline limit.

[10] Federal Register/Vol. 76, No. 223/Friday, November 18, 2011/Rules and Regulations, pp71635

There is therefore no reason to create a different ratio for natural gas, as is contemplated in the Interim Final Rule. The cash-settled limit for natural gas should be brought into line with the limit for all other commodities, and be set at a one-to-one ratio with the limit for physical-settled contracts. Nor should the CFTC countenance widening any of the ratios for other commodities, since to do so would be to invite and, indeed, incentivize the Classic Manipulation Scenario.

Moreover, as noted above, position limits are mandated not just to protect against manipulation, but also for excessive speculation. Given that the prevention of excessive speculation requires **tighter** limits than the prevention of manipulation, any reasonable analysis would conclude that a one-to-one ratio for physical-settled and cash-settled limits is appropriate, and that wider ratios should not be considered.[11]

Thus, even in the face of pressure from certain exchanges and/or market participants that might reasonably be expected to arise over time to widen the cash-settled limits (because of their economic interest in volume), the CFTC should bear in mind that the purpose of position limits is to protect the markets from manipulation and excessive speculation, that more volume does not necessarily mean more liquidity, and that incentivizing manipulative behavior goes against the CFTC's mandate and objectives.

CONCLUSION

The Interim Final Rule attempts to protect the integrity of the markets by reducing the incentives for manipulation of prices in the spot month. To this end, it is correct in restricting the ratio between position limits in physical-settled contracts and cash-settled contracts to one-to-one. The carve-out for natural gas, however, is unwarranted, and should be removed.

The CFTC should not consider widening any of the ratios for natural gas or for other commodities beyond one-to-one. This is a direct consequence of the logic of the Classic Manipulation Scenario as well as the fact that prevention of excessive speculation requires tighter limits than does the prevention of manipulation.

The Interim Final Rule lists five primary objectives: (1) The protection of market participants and the public; (2) the efficiency, competitiveness, and financial integrity of the futures markets; (3) the market's price discovery functions; (4) sound risk management practices; and (5) other public interest considerations.[12] To achieve these goals, and to achieve the greatest benefit for the least cost, the CFTC must drop the 5X carve out for natural gas, and set all cash-settled limits at a one-to-one ratio with respect to their physical-settled reference contract.

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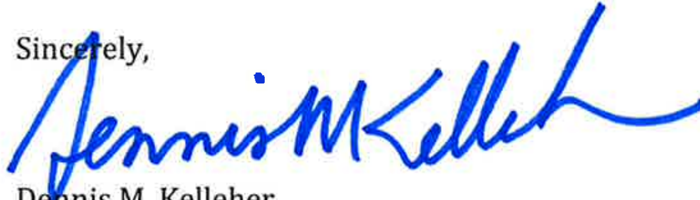
[11] For a discussion of why excessive speculation requires tighter limits than manipulation, see Position Limits Letter, note 2 *supra*. *See also* Better Markets Report, "Commodity Index Traders and the Boom/Bust Cycle in Commodities Prices," October 2011 *available at* http://www.bettermarkets.com/sites/default/files/BM%20Report%20CIT%20FINAL.pdf and Better Markets, "Position Limits for Futures and Swaps," January 13, 2011 *available at* http://www.bettermarkets.com/sites/default/files/CFTC-%20CL-%20Position%20Limits%20IFR-%201-13-12.pdf which are incorporated hereby as if fully set forth herein.

[12] *See* Note 5, *supra*.

We hope these comments are helpful.

Sincerely,



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