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Via Electronic Submission

Mr. Stephen Sherrod
Senior Economist
Division of Market Oversight
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Aggregation of Positions and *Bona Fide* Hedging Transactions

Dear Mr. Sherrod:

The Futures Industry Association ("**FIA**") appreciated the opportunity to meet with you and other CFTC Staff on December 12, 2012, to discuss possible new position limits rules that the Commodity Futures Trading Commission may consider in the near future. During the meeting, Staff indicated that it may recommend that the Commission propose new position limits rules in the following three phases: (1) aggregation requirements and exemptions; (2) exchange position limits on cash-settled contracts; and (3) federal position limits and *bona fide* hedging exemptions. Based upon the discussion during the meeting, FIA indicated that it would submit additional information for Staff's consideration as it develops new proposed rules related to position aggregation requirements and exemptions, and exemptions from position limits for *bona fide* hedging transactions. Should the CFTC decide to propose new position limits rules, we respectfully request that the Commission and Staff adopt the recommendations FIA makes below.

As Staff is aware, FIA's members, their affiliates, and their customers actively participate in the exchange-traded and over-the-counter derivatives markets as intermediaries, principals, and users.[1] Consequently, FIA and its members have a significant interest in any new position limits rules that the Commission may propose. In this regard, FIA filed comment letters

[1] FIA's regular membership is comprised of approximately 30 of the largest futures commission merchants ("**FCMs**") in the United States, the majority of which also are either registered with the Securities and Exchange Commission ("**SEC**") as broker-dealers or are affiliates of broker-dealers. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than 80 percent of all customer transactions executed on U.S. designated contract markets.

addressing the Commission's Part 151 proposed rule,[2] the Part 151 interim final rule,[3] the proposed amendments to the aggregation requirements,[4] and petitions filed by market participants requesting relief under CEA section 4a(a)(7) for certain commonly used hedging transactions.[5]

In connection with issuing any new proposed rules setting position aggregation requirements and related exemptions, and exemptions for *bona fide* hedging transactions and positions, FIA respectfully requests that the Staff and Commissioners consider:

- confirming, consistent with current Commission practice, that contingent and beneficial ownership interests do not constitute "ownership" for purposes of the aggregation rules;
- only requiring aggregation of positions of an owned entity on a *pro-rata* basis based on a person's ownership percentage of the owned entity;
- allowing market participants to rely on aggregation exemptions before making a notice filing;
- permitting market participants to disaggregate the positions of an entity in which it has an ownership interest subject to regulatory limitations, such as financial holding company interests held pursuant to merchant banking authority, and in other circumstances where separate management of positions is assured;
- not requiring aggregation of the positions of owned entities that only trade cash-settled contracts; and
- expanding the list of enumerated hedging transactions to include commonly used hedging transactions, and recognizing non-enumerated *bona fide* hedging.

Please note that FIA's comments in this letter are limited to the specific issues discussed during the December 12 meeting and do not reflect all of FIA's views related to any position

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[2] *See* Position Limits for Derivatives, 76 Fed. Reg. 4752 (Jan. 26, 2011). *See also* Letter from the FIA to David Stawick, Secretary, Commodity Futures Trading Commission (Mar. 26, 2011) (on file with the Commodity Futures Trading Commission); and Letter from the FIA to David Stawick, Secretary, Commodity Futures Trading Commission (May 25, 2011) (on file with the Commodity Futures Trading Commission).

[3] *See* Position Limits for Futures and Swaps, 76 Fed. Reg. 71626 (Nov. 18, 2011). *See also* Letter from the FIA to David Stawick, Secretary, Commodity Futures Trading Commission (Jan. 17, 2012) (on file with the Commodity Futures Trading Commission).

[4] *See* Aggregation, Position Limits for Futures and Swaps, 77 Fed. Reg. 31767 (May 30, 2012). *See* also Letter from the FIA to David Stawick, Secretary, Commodity Futures Trading Commission (June 29, 2012) (on file with the Commodity Futures Trading Commission).

[5] *See* Petitions filed by the Working Group of Commercial Firms on January 19, 2012 pursuant to Section 4a(a)(7) of the Commodity Exchange Act. *See also* Letter from the FIA to David Stawick, Secretary, Commodity Futures Trading Commission (Mar. 26, 2012) (on file with the Commodity Futures Trading Commission).

limits-related rules that the Commission may propose. Should the Commission publish a proposed position limits rule for public comment, FIA will, as it has in the past, provide the Commission with its comments and recommendations on the substance of the proposed rule.

I. The Commission Should Confirm that Contingent and Beneficial Ownership Rights Do Not Constitute Ownership for Purposes of its Aggregation Rules

We understand from our December meeting that the Staff does not consider contingent or beneficial ownership rights to constitute "ownership" for purposes of the CFTC's aggregation rules. FIA agrees with Staff's position and requests that the Commission state expressly in the preamble to, or the text of, any new aggregation rule that contingent and beneficial ownership rights are not subject to the position limits aggregation rules. Confirmation of Staff's practice would ensure consistent application of any new proposed aggregation requirements to all market participants.

II. Market Participants Should Only be Required to Aggregate Positions on a *Pro Rata* Basis Based on Their Percentage of Ownership of an Owned Entity

As we mentioned during the December meeting, FIA believes that where the CFTC requires aggregation on the basis of ownership, market participants should only be required to aggregate the positions of an owned entity on a *pro rata* basis. Under current rules, a person must aggregate 100 percent of the positions of an owned entity, regardless of whether the person has a ten, twenty-five, fifty or one hundred percent ownership interest. The absence of a *pro rata* apportionment of positions results in the aggregation of a single position multiple times. For example, where ten entities hold a ten percent interest in an owned entity, absent an aggregation exemption, the owners must each aggregate the positions of the owned entity. In this situation, the CFTC's existing rules have the effect of creating ten positions from one position of the owned entity.

FIA recommends that the CFTC propose aggregation rules that only require a *pro rata* allocation of positions of an owned entity to the owners.[6] *Pro rata* aggregation would provide a more accurate picture of the positions owned by market participants and should not pose any increased risk of excessive speculation or manipulation.

III. Market Participants Should be Permitted to Rely on an Aggregation Exemption for a Reasonable Period of Time Before Filing a Disaggregation Notice

Under the CFTC's Part 151 rules, a market participant generally could not rely on an aggregation exemption until it had filed a notice with the CFTC.[7] As discussed during the December 12 meeting, if the Commission proposes any new aggregation requirements and exemptions, it should not require market participants to file a disaggregation notice before they

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6 *See, e.g.,* 76 Fed. Reg. 71626, 71700 (Appendix 4, Statement of Commissioner Scott O'Malia).

7 *See* CFTC Rule 151.7(h).

are entitled to rely on an exemption. Instead, FIA recommends that the Commission adopt a notice filing grace period so that a market participant that is entitled to an aggregation exemption is not (1) required to aggregate positions, or (2) in violation of the rule simply because it has not filed the disaggregation notice before it relies on the exemption.

Assuming that a market participant qualifies for an exemption from aggregation, the Commission should allow the participant to rely on the exemption provided that it makes a disaggregation notice filing within a reasonable period, such as 90 days (the "**Filing Grace Period**"), from the date when it first relies on the exemption. Under FIA's proposal, if a market participant qualified for an aggregation exemption, but failed to file a disaggregation notice after expiration of the Filing Grace Period, the participant would have violated the notice filing requirement, but would not be required to aggregate positions that otherwise qualify for an aggregation exemption.[8] We believe that FIA's proposal would reduce the compliance burdens and costs incurred by industry, and, at the same time, retain the benefit of notice filings and transparency in the Commission's administration and enforcement of aggregation requirements and exemptions.

IV. The CFTC Either Should Not Restrict the Ownership Threshold of the Owned Entity Exemption or Propose Additional Exemptions When Regulatory Limitations or Analogous Circumstances Warrant Disaggregation

In commenting on the Commission's prior proposed aggregation rules, FIA consistently has recommended that the Commission permit disaggregation of owned entities regardless of ownership percentage provided that the trades and positions are separately managed and controlled. FIA's members, affiliates and their customers continue to believe that the Commission should permit disaggregation when market participants are subject to information sharing restrictions under applicable law and in analogous situations when they have appropriate policies and procedures in place to ensure independent management and control of trades and positions.

During the December meeting, FIA explained, for example, that merchant banking authority granted to financial holding companies ("**FHC**") under the Bank Holding Company Act permits an FHC to hold a sizable investment in a nonfinancial company (an "**MB Company**") regardless of the company's activities. Notwithstanding these ownership interests, which at times may exceed fifty percent, merchant banking regulations prohibit an FHC or its controlled private equity fund from routinely managing or operating the MB Company.[9] For this reason, FIA believes that it would be appropriate for the Commission to permit an FHC that

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8 FIA's proposed Filing Grace Period would not be available to a market participant that is required to aggregate positions with an owned entity.

9 *See* 12 U.S.C. 1843(k)(4)(H)(iv).

holds an ownership interest under merchant banking authority to disaggregate the positions of an MB Company, even where the ownership interest exceeds fifty percent.

Staff noted during the December meeting that the purpose of requiring aggregation based upon ownership is to address situations where ownership constitutes a proxy for control. When an FHC holds an interest in an MB Company under merchant banking authority, the merchant banking regulations prohibit the FHC from routine management and control of an MB Company. The types of activities that constitute routine management and control include serving as an executive officer of the portfolio company, and negative covenants that restrict the owned entity from making routine business decisions such as entering transactions in the ordinary course of business.[10] In these circumstances, the Commission need not be concerned that ownership is a proxy for control, even where the ownership interest exceeds fifty percent of the owned entity.

Although the merchant banking regulations may not prohibit an FHC from having some access to the MB Company's position information, the FHC nevertheless is prohibited from routine management or control of the company. To ensure that the FHC cannot use the MB Company's position information to influence the trading of the FHC, the CFTC could condition an aggregation exemption for an ownership interest held under merchant banking authority on the presence of effective information barriers between the persons controlling the Referenced Contract trading of the FHC and those controlling the trading and positions of any MB Company that it seeks to disaggregate.

The CFTC has recognized similar information barriers in the context of the independent account controller ("**IAC**") exemption. Consistent with IAC exemption, the information barrier should permit information to be shared solely for risk management purposes between persons responsible for risk management functions who do not control the trading decisions of the MB Company or FHC.[11]

The Staff also should consider permitting disaggregation in analogous situations, such as when private investment funds ("**PE funds**") hold ownership interests in excess of fifty percent in unrelated commercial enterprises ("**portfolio companies**").[12] Portfolio companies often utilize proceeds from these investments for operating capital and infrastructure development. Notwithstanding the equity investment, which may exceed fifty percent, the PE funds, like

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[10] *See, e.g.*, 12 C.F.R. 225.171(b).

[11] FIA requests that the CFTC not require an FHC to make a notice filing for ownership interests pursuant to merchant banking authority. These filings do not provide a meaningful benefit that would outweigh the cost of compliance because the merchant banking regulations already prohibit an FHC from exercising routine control over the owned entity. The Commission could condition a merchant banking aggregation exemption on a requirement to provide information to the Commission upon request.

[12] *See* Letters from the Private Equity Growth Capital Council to David Stawick, Secretary, Commodity Futures Trading Commission (June 29, 2012 and August 20, 2012) (on file with the Commodity Futures Trading Commission).

FHCs, generally are not involved in the day-to-day management of the portfolio company. FIA recommends that the aggregation rules permit PE funds and other similarly situated entities that are prohibited by their governing documents from participating in the day-to-day management of an owned entity to disaggregate positions subject to position limits regardless of the percentage of their ownership interest. Any such exemption could be conditioned on separate management and control of positions, including the existence of policies and procedures implementing proper information barriers between the owner and the owned entity.[13]

V. The CFTC Should Not Require Aggregation of the Positions of Owned Entities that Only Trade Cash-Settled Contracts

During our December meeting, we recommended that Staff consider amending the aggregation rules to provide that market participants are not required to aggregate the positions of owned entities that only trade cash-settled contracts and that are subject to independent management and control. As FIA has pointed out previously, the Commission has found that the potential for price distortion for cash-settled contracts is "negligible".[14] During our meeting, Staff mentioned that one of the main purposes for position limits on cash-settled contracts is to prevent a market participant from influencing a physical-delivery contract in order to benefit a leveraged cash-settled position. This should not be a concern where the owned entity only trades cash-settled contracts, and its trading is separately managed and controlled from the trading of the parent. Permitting a company to disaggregate the positions of an owned entity that only trades cash settled contracts would lessen the compliance costs incurred by market participants to implement any aggregation requirements proposed by the Commission without adversely affecting the benefits of aggregation in other circumstances.

VI. The CFTC Should Expand the List of Enumerated Hedges and Provide for Non-Enumerated Hedging

Under the CFTC's Part 151 rule, *bona fide* hedging transactions were limited to those transactions specifically listed in the rule ("**enumerated**" hedge transactions).[15] The only mechanism available under the prior rule to classify a "**non-enumerated**" transaction as a *bona fide* hedging transaction was to apply to the CFTC for an order granting "non-enumerated" hedging pursuant to CEA section 4a(a)(7).[16] FIA believes that the CFTC should expand the list of specifically enumerated transactions that were contained in rule 151.5, and provide a more flexible approach to classify non-enumerated transactions as *bona fide* hedges.

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13 Similar to the IAC exemption, these information barriers should permit information to be shared solely for risk management purposes between persons responsible for risk management functions who do not control the trading decisions of the owner or the portfolio company.

14 *See* letter from the FIA to David Stawick, Secretary, Commodity Futures Trading Commission (Jan. 17, 2012) (on file with the Commodity Futures Trading Commission) *citing* 17 C.F.R. § 38, Appendix B.

15 *See* CFTC Rule 151.5(a)(2).

16 *See* CFTC Rule 151.5(a)(5).

A. Expanding the List of Enumerated Hedge Transactions

The list of enumerated hedging transactions in CFTC rule 151.5 was originally based on the list of enumerated hedging transactions in CFTC rule 1.3(z)(2), which was developed for, and only applied to, legacy agricultural contracts. However, the exchange-set position limits for other physical commodities, such as energy and metals, did not restrict *bona fide* hedges to enumerated hedge transactions, but rather followed the general definition of *bona fide* hedging in CFTC rule 1.3(z)(1). During the Part 151 implementation process, market participants identified numerous hedging transactions in the energy industry that did not fall squarely within the list of enumerated transactions that historically applied to agricultural products.[17] FIA requests that staff incorporate the *bona fide* hedge transactions identified in various submissions to the CFTC into the list of enumerated hedge transactions.[18]

B. Non-Enumerated Hedging Transactions

FIA recommends that the CFTC continue to provide for non-enumerated hedging through the mechanism in existing CFTC rules 1.3(z)(3) and 1.47, which delegate the authority to grant non-enumerated hedges to Staff. This mechanism provides significantly more flexibility to the CFTC compared to the process in Part 151, which required a Commission order for non-enumerated hedging. In addition, CFTC rule 1.47 provides a timing mechanism for the resolution of whether a non-enumerated transaction should qualify as a *bona fide* hedging transaction. Essentially, market participants can treat the transaction as a *bona fide* hedge upon filing an application, and the application is deemed approved if the CFTC does not respond to the request within 30 days.

During the December meeting, Staff expressed concern that CFTC rule 1.47 does not provide Staff with sufficient time to review and decide upon non-enumerated hedging transaction applications. FIA understands Staff's concern. If the 30 day period is insufficient to review an application, the CFTC should expand the timing provisions. For example, the rule could provide that a market participant cannot rely on the *bona fide* hedge exemption immediately upon filing. However, a market participant could treat the transaction as a *bona fide* hedging transaction if the application is still pending 30 days after filing, and thereafter until the Staff addresses the application. This procedure would allow Staff sufficient time to make an initial review of whether the transaction qualifies under the statutory definition of *bona fide* hedging in CEA

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[17] *See* Working Group of Commercial Energy Firm Petitions.

[18] *See*, *e.g.*, Letter from the Working Group of Commercial Energy Firms, to David Stawick, Secretary, Commodity Futures Trading Commission (Jan. 20, 2012) (on file with the Commodity Futures Trading Commission); Letter from the American Petroleum Institute, to David Stawick, Secretary, Commodity Futures Trading Commission (Mar. 13, 2012) (on file with the Commodity Futures Trading Commission); Letter from the CME Group, to David Stawick, Secretary, Commodity Futures Trading Commission (Apr. 26, 2012) (on file with the Commodity Futures Trading Commission); and Letter from the Working Group of Commercial Energy Firms, to David Stawick, Secretary, Commodity Futures Trading Commission (Sept. 19, 2012) (on file with the Commodity Futures Trading Commission).

section 4a(c)(2), but also provide flexibility to allow market participants to treat transactions that are economically appropriate to the reduction of risk as *bona fide* hedge transactions. Staff would also be able to review the transaction in more detail and respond to market participants over time.

FIA appreciates the opportunity to provide additional information to Staff as it considers recommendations for a new rule setting aggregation and *bona fide* hedging transactions. Please contact Barbara Wierzynski, General Counsel of the FIA at 202-466-5460, if you have any questions about FIA's comments or recommendations.

Respectfully submitted,

Walt L. Lukken

Walter L. Lukken
President & Chief Executive Officer

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