

GasMart 2010 Conference

Futures and OTC Market Regulation and What it Means for the Natural Gas Purchaser

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This outline summarizes the comments of the Intercontinental Exchange, Inc. (ICE) on federal speculative position limits on referenced energy contracts proposed by the CFTC.

CFTC Summary from January 26, 2010 Federal Register:

The CFTC has proposed the implementation of federal speculative position limits for futures and option contracts in certain energy commodities. The Commodity Exchange Act of 1936 gives the CFTC the authority to establish limits on positions to diminish, eliminate or prevent excessive speculation causing sudden or unreasonable fluctuations in the price of a commodity, or unwarranted changes in the price of a commodity.

ICE Comment Letter Filed with the CFTC on April 6, 2010:

Our comment letter reflects the belief that position limits and position accountability levels can be updated in a manner that ensures market integrity without impacting the liquidity and competitiveness of US markets, and offers several recommendations toward that objective. The CFTC has shown that speculation has not resulted in an adverse impact on prices; however, we support measures that increase transparency and market confidence, while preserving broad and deep participation in the price discovery process.

Background:

- If policy changes are not carefully tailored to address actual problems in the market, changes could ultimately leave our country, its businesses, and American consumers in a *worse position in the long run*.
- No investigation or quantitative study has demonstrated that speculation was the cause of increased energy commodity prices in 2008.
- While Congress has proposed that the Commission have greater authority over the OTC markets, such authority has not yet been granted. The Commission should carefully consider the timing of the proposal given the limited powers of the Commission at this time.
- Important differences exist between the agricultural futures market – on which the Commission’s proposal is based – and the energy futures market. As such, modifications to the agricultural position limit regime are required to be adequately tailored and effective for energy.

In summary ICE recommends that:

- the Commission should set aggregate position limits across markets, but should consider whether the “all month” limit should apply across all contract months;
 - In determining position limits or accountability levels, the Commission should consider the entire size of the relevant energy market– both exchange-traded and OTC and both domestic and domestically-linked.
 - Given competitive markets and the fact that a number of exchanges can trade the same energy contract, ICE believes that the Commission, rather than an exchange,

- is the appropriate, neutral authority to set and administer aggregate position limits and hedge exemptions for U.S. energy futures or significant price discovery contracts.
- Imposition of “all month” position limits for these markets could sap vital speculative liquidity from long dated portions of the pricing curve. This is not simply a theoretical concern – if markets are inhibited from sending accurate future price signals that reflect rising demand, important energy infrastructure may not be built today that will be needed to meet tomorrow’s energy needs.
- the Commission should set spot month limits by differentiating between financially settled and physically settled markets;
 - Financially settled contracts serve an important function in the market, providing market participants with the ability to hedge exposure to the final contract settlement price without basis risk and allow them to avoid the risk of physical delivery that is attendant to a physically delivered contract.
 - While differentiating between physically settled and financially settled contracts is important and currently part of the Commission’s proposal, the Commission should consider (i) whether forcing these participants to leave the physically settled contract a full three days in advance of expiration is appropriate given the differences between physically and financially settled contracts, and (ii) whether having speculative traders exit the physical contract in this manner will impair price discovery by reducing liquidity and concentrating pricing power among a smaller group or market participants.
 - the Commission eliminate the anticompetitive exchange concentration limits;
 - The concentration limit is duplicative of the aggregate limit and entirely unnecessary.
 - ICE disagrees with setting an exchange concentration limit as such a limit ignores the premise that economically equivalent contracts operate as a single aggregate market, and such a limit may operate in an anticompetitive fashion.
 - Exhaustive hearings by Congress and the Commission over the last several years have concluded that economically equivalent contracts traded on two separate exchanges operate as *a single aggregate market*.
 - By design, a concentration position limit will impose smaller, or stricter, concentration limits in smaller markets. Applying a concentration limit for each individual exchange will inhibit competition by impeding liquidity in a competing market and effectively locking in the market share of existing exchanges. Slowly, over time, the dominant market will continue to gain market share, as liquidity attracts liquidity. In the end, the commission may create the opposite of its intention to foster a diverse, highly competitive market.
 - One of the Commission’s rationales for imposing the concentration limit is to create a market with a larger number of smaller participants. The Commission’s proposal does not mention any study of the derivatives markets where the Commission has determined that crowding out is occurring, or that a concentration limit creates an influx of smaller market participants, nor what benefit a larger number of smaller participants would bring to the market.
 - A position accountability regime rather than an exchange specific concentration limit would serve the Commission’s purpose. Accountability level regulation, by design, is intended to serve as an early warning system that triggers heightened surveillance by and contact from the exchange and puts the trader “on notice.” Position accountability levels are set low for this very reason.
 - the Commission should not adopt the hedge exemption or risk management regime that ban

firms with hedge or risk management exemptions from holding a speculative position;

- The Commission should administer hedge exemptions and risk management exemptions in a transparent, market neutral manner. The Commission should keep the current hedge exemption and risk management regime, but should undertake the hedge exemption and risk management process at the Commission level.
- For hedge exemptions, the Commission is proposing a departure from the current agricultural position limit regime and past Commission practice. The proposed hedge exemption provision would exempt *bona fide* hedging transactions from position limits, but unlike the agricultural position limit regime and current Commission practice, the new hedge exemption regime would prohibit a trader with a *bona fide* hedge exemption from holding a speculative position unless the speculative position is in the spot month.
- It is important to note that swaps dealers *are offsetting risk and transferring off-exchange positions* to transparent and centrally cleared markets. This is a stated goal of financial reform in every proposed bill under consideration by Congress. The Commission's proposal is at odds with these goals and would greatly impair the ability of swaps dealers to drive positions to exchange traded and cleared markets.
- the Commission should consider an exemption for passive investors;
 - Limiting ETF or index fund participation in the exchange traded derivatives markets will have three consequences: (i) it will expose retail passive investor customers to bilateral credit risks; (ii) it will increase price volatility and reduce liquidity; and (iii) it will force more retail customers to access the futures markets directly.
 - In light of these facts, the Commission should consider allowing passive investors, such as ETFs or index funds, to have a separate position exemption to speculative limits.
- the Commission should not eliminate the independent account controller exemption
 - The Commission offers no explanation for its decision to depart from previous practice, other than stating that the independent controller exemption “would allow traders to establish a series of positions each near a proposed outer bound position limit without aggregation, may not be appropriate.”
 - Firms with decentralized and international trading operations through multiple independent account controllers would find it extremely difficult, and very costly, to track position limit levels for each of these disparate trading operations in the over 100 unique contracts affected by the proposal.