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trade them
for anything.*

COMMENT

October 19, 1998

VIA FACSIMILE, FEDERAL EXPRESS AND ELECTRONIC MAIL

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

COMMODITY FUTURES
TRADING COMMISSION
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Re: Proposed Revision of Federal Speculative Position Limits and
Associated Rules 63 FR 38525 (July 17, 1998)

Dear Ms. Webb:

The New York Mercantile Exchange ("NYMEX" or the "Exchange") appreciates the opportunity to comment, on its own behalf and on behalf of its wholly-owned subsidiary, Commodity Exchange, Inc., to the Commodity Futures Trading Commission ("CFTC" or the "Commission") on the proposed revision of federal speculative position limits and associated rules ("the Proposal"). In particular, the CFTC, through the addition of proposed new Regulation § 150.5 ("Exchange-set speculative position limits"), has proposed to codify certain informal policies and administrative practices relating to how exchanges should set speculative position limits and set position accountability rules as substitutes for speculative position limits in certain contracts.¹

NYMEX is a not-for-profit corporation organized under the laws of the State of New York. It has been designated by the Commission as a contract market for the trading of numerous commodity futures and commodity futures option contracts. NYMEX is the largest exchange in the world for the trading of futures and option contracts based on physical commodities. Public investors in our markets include institutional and commercial producers, processors, marketers and users of energy and

¹With regard to agricultural contracts for which federal speculative position limits are established directly by the CFTC, the Commission also has repropoed to raise the raise the back month speculative position limits to levels proposed initially in 1992. Because the proposed limits would not affect NYMEX's markets, the Exchange has no comments on these proposed changes.

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The New York Mercantile Exchange is composed of two divisions. The NYMEX Division offers trading in crude oil, heating oil, unleaded gasoline, natural gas, electricity, propane, platinum, and palladium. The COMEX Division offers trading in gold, silver, copper, and the Eurotop 100® index.

metals products.

I. Overview

Like the Commission, futures exchanges have a strong interest in assuring the integrity of their markets, and the establishment of speculative position limits is one tool that has long been used by exchanges to monitor these markets. Contract markets are presently required by Commission Regulation § 1.61 to maintain position limits (or position accountability rules as an exemption to the general requirement) for each futures contract that is listed for trading. It is worth noting, however, that in April 1975, well before the implementation of this mandatory requirement, exchanges had placed position limits in effect for almost all actively traded commodities then under regulation, even though federal speculative position limits were in effect for only a few specified agricultural commodities.² In addition, at the time that Regulation § 1.61 was first proposed, contract markets at that time had voluntarily placed position limits on 23 contracts involving 17 commodities.³

While speculative position limits can function as an important tool in maintaining market integrity, such limits must be set with great care. As the Commission noted in promulgating the final initial rules for Regulation § 1.61, "[s]peculation is often an important contributing factor to market liquidity and pricing efficiency."⁴ In other words, how and where speculative position limits are set can have a substantial impact upon market liquidity. Speculative position limits also should be set by considering in part how markets operate and how market participants respond to such limits. For example, it is the Exchange's understanding that certain commodity pools try to comply with speculative position limits for futures contracts by establishing internal control procedures that set a maximum position size, e.g., 75% of the speculative position limit, that is well below the actual limit.

The setting of proper speculative position limits is especially critical because use of inappropriately designed speculative position limits could restrict liquidity and the additional competitive component brought to futures markets by speculative investors. In addition, use of inappropriate speculative position limits could result in a further shift

²45 FR 79831 at 79831 (December 2, 1980).

³*Id.*

⁴46 FR 50938 (October 16, 1981), reprinted in ¶ 21, 256, Comm. Fut. L. Rptr. (1980-1982 Transfer Binder) 25, 258 at 25, 262.

away from the transparent markets provided by domestic futures exchanges in favor of foreign futures exchanges or unregulated over-the-counter markets.

The Proposal is intended to codify what has been recent informal practice followed by Commission staff in reviewing speculative position limits and position accountability rules proposed by futures exchanges. NYMEX suggests that the Commission use this opportunity to reexamine the appropriate roles of the Commission and the exchanges in pursuing their shared goal of market integrity. The Commission has capable and experienced staff to monitor the many markets falling within the Commission's jurisdiction. However, the Commission should acknowledge that, with regard to the products that are traded at a particular futures exchange, that exchange is the leading expert on its own markets and on market activity in those markets. Because of the enormous potential reputational and business risks associated with any manipulative activity occurring on an exchange, futures exchanges have very strong incentives to monitor their markets with care to prevent such occurrences.

Accordingly, NYMEX submits that futures exchanges are best positioned to establish speculative position limits for their markets and should be given sole responsibility to do so. Under the Commodity Exchange Act ("Act"), boards of trade have an initial and a continuing obligation for designation as a contract market to provide for the prevention of manipulation of prices; allowing futures exchanges to have sole responsibility for setting limits in their own markets would be consistent with these statutory responsibilities.

The codification of informal practices in proposed new Regulation § 150.5 would appear to remove the flexibility that was perceived to be available under the informal procedures. Therefore, even if the Commission determines not to undertake an assessment at this time of the appropriate degree of self-regulatory organization responsibilities for speculative position limits, the CFTC, at a minimum, should consider revising proposed new Regulation § 150.5 to provide exchanges with sufficient flexibility to address the differing conditions in their respective markets.

II. Position Limits at Designation

First, under proposed new Regulation § 150.5, exchanges would need to establish speculative position limits at the time of a contract's initial designation. NYMEX suggests that the Commission add language that would permit exceptions to this general requirement. Thus, an individual exchange could make its case to CFTC staff to justify that an exception was warranted for a particular contract.

Second, under the Proposal, the spot month limit level for physical delivery contracts could be no greater than one-quarter of the estimated spot month deliverable supply (calculated separately for each month to be listed). The basis for using this

standard as the sole criterion is unclear. In addition, the Exchange is concerned that limiting the evaluation to only one criterion would provide no flexibility for setting a higher limit. In this regard, the Commission has previously noted that the limits that are appropriate for certain commodities, such as agricultural commodities, may not be appropriate for other tangible or intangible commodities.⁵ Therefore, NYMEX suggests that the CFTC should incorporate in any final rule an exception that would permit an exchange to request and justify an increased spot month limit.

Finally, non-spot month and all-months-combined levels could be no greater than 1,000 contracts for tangible commodities other than energy products, such as metals contracts, and non-spot month and all-months-combined levels could be no greater than 5,000 contracts for energy products and "non-tangible" commodities, including contracts on financial products. In the Proposal, these limits appear to be based upon the informal "rule-of-thumb" measures used previously by CFTC staff. However, there is no formal analysis in the Proposal that justifies the establishment of these limits. In addition, NYMEX is concerned that these standards would provide no flexibility for instances where a particular contract might have exceptional circumstances that could warrant higher limits than permitted by these criteria. Thus, NYMEX suggests that the CFTC provide a justification for use of these limits and also add an exception that would permit an exchange the opportunity to apply for and justify higher limits.

III. Adjustments of Position Limits

With regard to adjustments by an exchange of the initial position limits for a contract, the new rule would provide that exchanges could apply to adjust such levels no earlier than 12 months following designation. It is unclear why exchanges should be required to wait one year before attempting to adjust their position limits. In particular, this requirement would severely limit the ability of an exchange to adjust limits in response to market conditions prior to the end of this 12-month period. Thus, NYMEX recommends that the CFTC eliminate this restriction.

Under the Proposal, the speculative position limits for the spot month limit of a physical delivery contract could be adjusted but could never exceed one-quarter of the estimated spot month deliverable supply. The Exchange notes that adjustments to speculative limits that are proposed subsequent to designation present an opportunity to consider other data not available to Commission staff at the time of designation. For example, in NYMEX's experience, standard deliveries of energy contracts over time represent less than 1% of trading volume, and trading volume typically represents a multiple over cash market volume at the delivery location. CFTC staff should take

⁵57 FR 12766 (April 13, 1992), reprinted in ¶ 25, 268, Comm. Fut. L. Rptr. (1990-1992 Transfer Binder) 38,855 at 38, 860.

advantage of the availability of these and other data when reviewing proposed revisions in position limits. Therefore, NYMEX recommends that the CFTC should not restrict its analysis to the deliverable supply but instead also should consider, among other things, the level of open interest in the contract, the quantity of contracts taken to standard delivery as a percentage of trading volume and the multiple over cash market volume at the delivery location that such futures trading volume represents.

Under the Proposal, non-spot month and all-months-combined limits could be adjusted to a level no greater than 10 percent of the average combined futures and delta-adjusted option month-end open interest for the most recent calendar year - up to 25,000 contracts, with a marginal increase in the speculative position limit of 2.5 percent of open interest above 25,000 contracts.⁶ Alternatively, non-spot month and all-months-combined limits could be based on position sizes customarily held by speculative traders on the contract market, which could not be extraordinarily large relative to total open positions in the contract. Here also, the Exchange believes that, in order to provide for sufficient flexibility, the Commission should add language that allows for exceptions to this methodology.

The Commission also proposes to consider the liquidity of the underlying cash market, although a quantifying measure of such liquidity was not included in the proposed rule. NYMEX does not object to the proposed consideration by CFTC staff of liquidity in the underlying cash market (when evaluating a request to adjust position limits) and supports the Commission's determination not to codify an acceptable measure of cash market liquidity at this time.

IV. Position Accountability as a Substitute for Speculative Position Limits

Under the Proposal, an exchange could request approval from the Commission to adopt position accountability rules in place of speculative position limits beginning 12 months after a contract's initial listing. For futures and option contracts on financial instruments, the Commission would establish requirements for position accountability that vary depending on open interest and trading volume.

Similarly, for futures and option contracts on a tangible commodity, such contracts would not be eligible initially for position accountability treatment unless those contracts had an average month-end open interest of 50,000 contracts and an average daily volume of 5,000 contracts. For these types of contracts, a position accountability rule would need to require traders to provide information and to consent to halt any

⁶Thus, for example, if a particular non-spot month had month-end open interest of 35,000 contracts, the applicable speculative position limit for that month would be 2750 contracts (2500 contracts + 2.5% of 10,000 contracts).

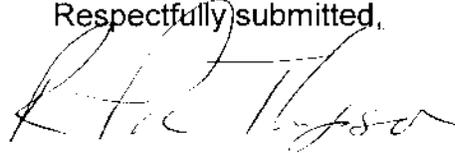
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further increases in that trader's positions if so ordered by the exchange, regardless of average daily trading volume. NYMEX does not object to the particular methodology proposed for the calculation of trading volume and month-end open interest. Still, in order to provide for sufficient flexibility, the Exchange suggests that the Commission should add language that allows for exceptions to this methodology.

* * * *

NYMEX thanks the Commission for the opportunity to submit comments concerning the proposed amendments and would be pleased to furnish additional information in this regard. If you have any questions, please do not hesitate to contact the undersigned.

Respectfully submitted,



R. Patrick Thompson
President

cc: Chairperson Brooksley Born
Commissioner Barbara P. Holum
Commissioner James E. Newsome
Commissioner David D. Spears
Commissioner John E. Tull, Jr.