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Hearing on Energy Position Limits and Hedge Exemptions
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Introduction

Chairman Gensler, Commissioners and staff of the CFTC, my name is Blythe Masters. I am a Managing Director and Head of the Global Commodities Group at J.P.Morgan and the Chair of the Securities Industry and Financial Markets Association (SIFMA). I thank you for the opportunity to provide testimony at this hearing. J.P.Morgan's commodity business provides thousands of commercial, industrial and financial customers with risk management and transactional services in both physical and financial commodities globally.

The issues we are addressing today, the application of position limits and exemptions to those limits, play an important function in the proper functioning of commodities markets by ensuring that market activity is not undermined by excessive speculation. J.P.Morgan wholeheartedly supports efforts to prevent excessive speculation as well as to improve the regulatory framework for "over the counter" (OTC) derivatives. We also believe that those efforts must be undertaken with the broader understanding that speculation itself plays an essential role in commodities markets. If investors were discouraged or prevented from assuming price risks, hedgers would have much more difficulty entering into transactions, markets would be more volatile and the CFTC's mission of protecting risk management and price discovery would be compromised. As a result, we believe it is essential that restrictions on market activities such as position limits and exemptions, which are intended by statute to address excessive speculation, must be tailored to fit that intent.

In discussing position limits and exemptions, it is critical to consider the role they play in facilitating risk management through over-the-counter (OTC) derivatives transactions. As the Commission is aware, the vast majority of large American companies, and a significant percentage of all other American companies, enter into OTC derivatives transactions to hedge risks that arise out of their core businesses. Financial intermediaries such as J.P.Morgan stand between those entities that want to offload risk, typically in the OTC market, and those entities that want to take on risks. Intermediaries aggregate risks assumed in this way from multiple parties and manage the resulting net positions on a portfolio basis. Typically, dealers flatten out such net portfolio risk positions on designated contract markets and exempt commercial markets, which for ease of reference I shall refer to as exchanges. Thus, for risk management purposes, exchange and OTC markets are used interchangeably, and the ability of a financial intermediary, or swap dealer, to use exemptions to position limits to effectuate OTC transactions is key to being able to provide risk management tools to its customers.

Before discussing the specifics of how position limits and exemptions affect OTC markets, I thought it might be useful to describe who participates in the OTC markets.

OTC Commodity Derivatives

The most active commodity hedgers are companies like producers, manufacturers, utilities and airlines that face material risks to their financial performance arising from the effects of commodity price risks on their day to day operations. Hedging often represents the only opportunity for such firms to protect against adverse price movements and to lock in predictable margins. For example, airlines frequently hedge their jet fuel costs through OTC jet fuel swaps, and utilities often hedge their fuel costs, through OTC natural gas swaps, and their production, through OTC power purchase agreements. Many of these activities cannot be conducted on exchanges, which do not offer the customized contracts that are found OTC. For example, there is no jet fuel futures contract. Effective hedging depends on the firm's experience, personnel and management approach. Firms with good hedge risk management programs can use this stability to reduce the cost and increase availability of funding or to lower prices to customers. Time and again, the difference between hedging and not has been the determining factor in the viability of plans to develop major new investment projects.

On the other side of such transactions is often an investor who enters into OTC transactions to obtain exposure to price movements of commodities. Commodities offer diversification to investors and, with respect to inflation, a more correlated hedge than other investments in the market. In a recent survey of inflationary expectations among J.P.Morgan's institutional investor client base, more than 20% of 1800 respondents had used commodities to hedge against future inflation. Investors are an important part of the commodity markets and their participation has been beneficial because historically, more producers of commodities were interested in hedging than purchasers and because often when producers wish to sell is not when consumers wish to buy. Investors fill these gaps by acting as the economic equivalent of purchasers and providing liquidity to facilitate producer hedging. Consequently, they aid in efficient and smooth price discovery. Importantly, such investors do not take delivery of the underlying physical commodities and as such have no mechanism for withholding or hoarding supplies from actual consumers. For every buyer of a futures contract, there is a corresponding seller. Furthermore, once investors' initial investment allocations are made, positions are typically rolled forward each month with each contract being *sold* prior to expiry. For sustained upward pressure on prices, investors would have to continuously add to their allocations through time. In fact, our experience shows that more typical behavior is for investors to sell following price appreciation and vice versa in order to maintain constant dollar values invested. This tends to stabilize price action rather than drive it. We are aware of no credible academic study or analysis that demonstrates that the presence of non-commercial interests in commodity markets has been detrimental and many that reach the reverse conclusion.

OTC and Exchanges

OTC markets and exchanges work in tandem in the markets and facilitate the efficient transfer of risk in the economy: swap dealers use commodities exchanges to, among other things, hedge net economic positions arising from their physical and OTC transactions. Hedging involves taking a position in a futures market opposite to a position held in the cash or OTC derivatives market to minimize the risk of financial loss from an adverse price change. It can also involve a purchase or sale of futures as a temporary substitute for a cash transaction that will occur at a later date. One can hedge either an effective long cash market position (i.e. one owns the cash commodity) or an effective short cash market position (i.e. one plans on buying the cash commodity in the future). Importantly, managing risk on a portfolio basis in this way requires the intermediary to assume "basis risk". Basis risk occurs when an underlying position is hedged with an offsetting position which is expected to approximately but not exactly offset the risk of the underlying position. For example, it is common for a dealer to hedge power prices with natural gas, to hedge jet fuel prices with WTI crude oil, to hedge options with futures and to hedge long dated (e.g. 10+ year) risk with shorter dated positions (e.g. 1-3 years). The willingness of dealers to risk capital by assuming basis risk between futures and OTC markets is a vital contribution to the liquidity enjoyed by their customers.

As entities transacting on the exchange, dealers are subject to the speculative position limit and accountability levels with respect to each commodity in which they transact. A position limit is the maximum position, either net long or net short, in one commodity future or option or in all futures or options of one commodity combined that may be held or controlled by one person other than a person eligible for a hedge exemption by an exchange and/or by the CFTC. Hedge exemptions, which provide an exemption from speculative position limits for bona fide hedgers and certain other persons who meet the requirements of exchange and CFTC rules, are critical because they allow a swap dealer to execute risk management transactions in the OTC market and hedge those on the exchange.

Hedge exemptions are granted for specific purposes and are limited in amount and duration. Generally, a market participant must apply to the exchange and/or the CFTC for an exemption. The application for the hedge exemption must include the business rationale for the exemption and the overall swap and/or cash exposure being hedged. The swap dealer must show that its trading in futures would offset its actual net economic exposure from OTC transactions in an economically appropriate manner. The CFTC and exchanges also may impose additional regulatory conditions on the dealer. These restrictions and safeguards ensure that hedge exemptions are used for their designated purpose. A dealer acting in its own capacity as a speculator is not and should not be exempted from any restriction that is applicable to any other entity.

CFTC Special Call

Through its legislative mandate, the CFTC has a responsibility to surveil the activity of participants on commodities exchanges to protect against fraud and manipulation. While the CFTC receives information from exchanges and clearing brokers, the Commission found this information insufficient to fulfill this responsibility and, in June 2008, issued a Special Call to Swaps Dealers as part of an initiative to increase transparency in futures markets.

For the initial submission pursuant to the Special Call, respondents were required to provide monthly data beginning with December 2007 activity through June 2008, with an ongoing obligation to provide data on a monthly basis thereafter (we continue to provide the data). In its current form, swap dealers must provide the following on a monthly basis:

- Their Commodity Index Swaps Business with a total notional value of $100 million or greater.

- Their total index investments by commodity and client type, including
  - the gross long and short notional values for only U.S. commodity futures market by market, the aggregate total for all non-U.S. markets, and the aggregate total for all markets;
  - the futures equivalent[1] gross long and short positions by U.S. commodity futures market; and
  - identifying for each U.S. commodity futures market the positions in aggregate by the types of clients/counterparties as index funds, institutional investors, sovereign wealth funds, and "other." [2]

- Their non-index commodity swaps business (i.e., essentially, non-cleared single-commodity swaps). This includes reporting:

  - the gross long and short notional value by U.S. commodity futures market;
  - the futures equivalent gross long and short positions by U.S. commodity futures market; and

[1] "Futures equivalent positions" includes futures and delta-adjusted options and is provided based upon all outstanding OTC transactions regardless of whether the transaction resulted in an open futures position on the exchange, i.e., it includes a calculation of positions that were not traded in the futures market because they were offset or netted internally.

[2] For the purposes of the report, an "index fund" means a client/counterparty with a fiduciary obligation to match or track the results of a commodity index, including ETFs and ETNs based upon a commodity index; an "institutional investor" shall include pension funds, endowment funds, and other similar investors; a "sovereign wealth fund" means a non-U.S. government entity, including, for example, a government investment company or a government-run pension fund; and "other" refers to any other client, including those that would be described as unknown or intermediary.

- by market the aggregate counterparty[3] positions, gross long and short, as non-commercial, commercial, and intermediary.

- The identity of each client/counterparty whose total notional value with the reporting dealer represents a futures equivalent position equal to or greater than 25% of the applicable CFTC or exchange single-month or all-months position limit or position accountability level for any U.S. commodity futures market. For each such counterparty, the following must be provided:

  - the counterparty name
  - the market name and exchange code
  - futures expiration month
  - total futures equivalent contracts
  - the classification of the index client (i.e. index fund, institutional investor, sovereign wealth fund, other)
  - the classification of non-index swaps counterparties (i.e. commercial, non-commercial, and intermediaries)

While the primary goal of the Special Call was to enhance the integrity of futures markets by increasing the quantity and quality of information on trading, the Special Call has also provided the CFTC with information regarding activity in OTC markets and yielded very useful information for dealers about the market. Though setting up the information-gathering and reporting process was time consuming and expensive, J.P.Morgan has found that the information requested in the Special Call has been useful beyond the regulatory purpose it serves. We also believe that information gathered through the Special Call allows for a new way for the CFTC to establish position limits, as we propose below.

Proposals

1. Large Trader Reporting System for OTC Positions

J.P.Morgan recommends that the Commission further enhance the Special Call to implement a comprehensive reporting system that will give the Commission the data necessary to view an entity's aggregate positions in over-the-counter ("OTC") contracts. This system would serve the same purpose as the Commission's existing Large Trader Reporting System ("LTRS"), which gathers information from designated contract markets, clearing members, futures commission merchants, foreign brokers, and traders, and allows the Commission to surveil aggregate positions in exchange-traded contracts that rise to a threshold level. This new OTC LTRS would give the Commission the same capability for OTC positions based on data submitted by swap dealers in their monthly Special Call reports. Most of the data required for this new OTC LTRS is collected through the Special Call. The key enhancement required to implement the OTC LTRS is a mechanism for aggregating position data for persons that are reported by multiple swap dealers.

2. Single Position Limit across All Markets

J.P.Morgan believes that the CFTC should take the information that it obtains from all swap dealers from the Special Call, including the LTRS report, and establish a speculative position limit that applies to each

[3] For the purposes of the report, a "commercial" means a client/counterparty who has market risk arising from physical market activities in the subject commodity, and the swap agreement is part of a risk-management strategy; the "intermediaries" category includes clients/counterparties that are intermediaries (other swaps dealers, banks, etc.) for whom the swap dealer has no information on whether they are acting on behalf of noncommercial or commercial clients.. All other counterparties are shown as "non-commercial."

participant's net economic position after taking into account exchange and OTC positions. In effect, the CFTC should look through the swap dealers and apply position limits at the market participant level. This would eliminate the ability to use the OTC markets to exceed positions that would otherwise apply if the participant had transacted on regulated exchanges, furthering the mission of preventing excessive speculation.

3. Preserve Hedge Exemptions

J.P.Morgan believes exemptions from position limits should continue to be permitted to facilitate transactions by entities other than hedgers who are in the conduct and management of a commercial practice**.** Hedge exemptions for transactions related to a non-commercial practice are necessary to allow financial intermediaries to mitigate their exposure to those transactions. Those transactions are vital to the counterparties entering into them for risk management or investment purposes, both of which are legitimate and important objectives. Concerns about excessive speculation could be addressed properly through the position limits applicable to each of those counterparties.

Systemic Risk

Lastly, I would like to turn to the issue of systemic risk, which is at the heart of the current financial crisis and which J.P. Morgan believes needs to be addressed by reforms to our regulatory system, including reforms to the regulation of OTC derivatives. J.P.Morgan believes that entities that engage in transactions in the financial markets and whose failure would have implications to the entire market should be regulated by a systemic risk regulator that will oversee all systemically significant financial institutions. This regulator would have the capability to impose capital requirements on these institutions, to oversee their transactions with each other and with their customers, and to impose conditions on those transactions, such as collateral requirements.

In addition, J.P.Morgan believes that all standardized OTC derivatives transactions between systemically significant financial institutions should be cleared through a regulated clearinghouse. The standardization requirement is necessary because only transactions with a degree of standardization are capable of being risk-managed by the clearinghouse and thus be eligible for clearing. The limitation to systemically significant institutions is necessary because many end-users, who have a critical need to manage risk, can only enter into OTC derivatives; they do not have the cash or the operational resources to undertake trading through a clearinghouse, even for standardized transactions. End-users still will be able to choose to trade through a clearinghouse – they just should not be required to do so.

Exposure to end-users that is either secured by assets that a clearinghouse can't accept (e.g. property, reserves, equipment, commodities) or is unsecured does not pose a systemic risk. From the standpoint of the end-users, the ability to pledge this kind of collateral or to transact on an unsecured basis is very favorable, as it allows them to enter into risk management using the assets that they own in their businesses with no disruption to those businesses and without draining their liquidity to come up with cash. From the standpoint of the dealers, exposure to these end-users often is what is referred to as "right-way risk" in that the exposure moves in the same direction as the value of the collateral or the overall business. For example, if a natural gas producer wants to hedge its production, it will enter into a natural gas swap with J.P.Morgan in which it pays J.P.Morgan a floating price and receives a fixed price, and it might pledge its gas reserves as collateral to secure the swap. If gas prices go up, J.P.Morgan has increased credit exposure on the swap, but the value of its collateral also has increased and the overall enterprise value of the producer has increased, so from a credit standpoint J.P.Morgan does not face increased risk. The mitigation from right-way risk applies to unsecured exposure as well – if an exposure is "right way" a dealer is more likely to extend unsecured credit because the client's overall credit-worthiness tends to improve as the exposure grows.

More generally, extending credit is a core activity for derivatives dealers like J.P.Morgan and is good for the overall economy. At year end 2008, J.P.Morgan had net counterparty credit exposure from its OTC derivatives trades of $143 billion, $10 billion of which was hedged. Of the remaining $133 billion of exposure, 85% was to entities that were rated investment grade, and some of this exposure was secured by the kinds of collateral that I mentioned above: property, equipment, reserves, etc. Across all its lines of business, JPMorgan Chase & Co. had $745 billion of loans extended as of year end 2008. This exposure and these loans help our customers grow their businesses and finance their activities, and taking prudent credit exposure as J.P.Morgan does, particularly in these precarious economic times, should not be discouraged by excessively restrictive legislation or regulation.