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Subject: Dodd-Frank Act Rulemaking XXVI. Position Limits, including Large Trader Reporting, Bona Fide Hedging Definition & Aggregate Limits
Attach: Overview of US Commodity Markets and Position Limits and Exemptions.pdf

Attached please find a copy of a presentation submitted today, October 7, at a meeting with CFTC staff in connection with the rulemaking area of Position Limits, including Large Trader Reporting, Bona Fide Hedging Definition & Aggregate Limits.

Sincerely,
William F. McCoy

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Morgan Stanley Commodities

Overview of the US Commodities Markets and Position Limits and Exemptions

October 2010

Typical Business Activities

Market Activities that Morgan Stanley Commodities and similar firms engages in include:

- Trading Financial and Physical Commodities, including:
 - Oil Liquids, Natural Gas, Power and Biodiesel Products
- Producer and Commercial Consumer Hedging
- Jet Fuel Supply to Airlines (inc. working capital agreements)
- Wholesale Distribution of Diesel and Gasoline
- Tolling Agreements for Power Plants
- Managing Storage, Transportation and Transmission Contracts
- Off-Take agreements for Wind Power producers
- Real-Time Power Trading
- Trading in Renewable Energy Certificates and Emissions Credits

Most, if not all, of these activities involve acting as a Dealer in swaps or the underlying physical commodities, engaging in market-making and in the warehousing of risk

The Dealer / Market Maker Function

Pricing – Competitive and Transparent

- Has become very competitive due to high number of market participants and high levels of liquidity
- Growing sophistication of End Users due to increased access to pricing sources

Risk Management

- Dealers provide liquidity and manage risks through:
 - Futures Market Trading
 - Inter-Dealer Market
 - Customer business (Buyers and Sellers)
 - Warehousing of Risk, including participation in cash markets

Buyers and Sellers rarely line up to offset each other

- Mismatches in timing of execution, products, delivery locations, tenor of positions and volumes are inevitable in the real world

Warehousing of Risk – Liquidity is Crucial!

Key Feature of the Market is Liquidity

Benefits include:

- Price transparency and competition between dealers = low transaction costs
- Reduced price volatility
- Increased capacity for hedging activity
- Liquidity develops as all market participants increase their level of comfort and risk takers and ‘warehouseers’ of risk are confident of the market dynamic

The current market enjoys ample liquidity due to:

- A large number of dealers and market participants
- Very competitive pricing available to hedgers (bid-offer spreads)
- A well functioning clearing mechanism combined with financial dealers offering non-margin based trading lines to commercial hedgers

New Position Limits and Exemptive Authority

- The Commission is authorized to set position limits for exempt and agricultural commodities
- The Commission also is required to define what constitutes a bona fide hedging transaction
- Position limits (and related hedge exemptions) must be based on an entity's aggregated net position in futures, exchange-traded swaps, and SPDCs
- The Commission should propose a Position Limit Rule that does not adversely affect the liquidity or price discovery function of the Commodity Futures and Swaps Markets
- Consideration of the fact that market flow mismatches need to be absorbed is crucial!
- An Overly Restrictive Position Limit Regime will result in increased volatility and decreased capacity for hedging activity

New Position Limits and Exemptive Authority

- The Position Limit Rule Should Aggregate Accounts based only on Common Control
- The Position Limit Rule Should Establish Position Limits that Remain Predictable
- The Position Limit Rule Should Include a Definition of “Bona Fide Hedging Transaction” that provides flexibility and certainty
- The CFTC has Broad Exemptive Authority

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