

**Morgan Stanley Commodities**

# Overview of the US Commodities Markets and Position Limits and Exemptions

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## 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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