MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

February 10, 2009

Via Electronic Mail: secretary@cftc.gov

David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Significant Price Discovery Contracts on Exempt Commercial Markets, 73 *Fed. Reg.* 75888 (December 12, 2008)

Dear Mr. Stawick:

The Managed Funds Association ("MFA")[1] appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("Commission") proposed rules on "Significant Price Discovery Contracts on Exempt Commercial Markets" ("Proposed SPDC Rules").[2] MFA and its members commend the Commission on the proposed rules and support the Commission's efforts to implement the CFTC Reauthorization Act of 2008[3] ("Reauthorization Act") through this rulemaking.

The Reauthorization Act

The Reauthorization Act significantly expanded the Commission's oversight authority with respect to exempt commercial markets ("ECMs") having Significant Price Discovery Contracts ("SPDC"). Exempt commercial markets were first recognized as a regulatory category in 2000 as part of the modernization of the Commodity Exchange Act[4] ("Act") which implemented a system of tiered regulation to replace the prior one-size-fits-all regulatory

---

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

[2] 73 *Fed. Reg.* 75888 (December 12, 2008).

[3] Incorporated as Title XIII of the Food, Conservation and Energy Act of 2008, Pub. L. No. 110-246, 122 Stat. 1624 (June 18, 2008).

[4] 7 U.S.C.§ 1 *et seq.*

scheme.[5] At that time, ECMs were electronic trading platforms on which sophisticated commercial participants traded on a principal-to-principal basis in a manner that largely resembled a business-to-business trading facility. Based on these characteristics, ECMs were not required to be licensed or registered by the Commission, but were subject to various requirements, including certain notification, recordkeeping and reporting requirements. In contrast to fully-regulated designated contract markets ("DCMs"), ECMs were not required to meet self-regulatory requirements, such as monitoring the trading of large position holders, imposing position accountability rules or speculative position limits, or adopting and operating a compliance program.

Over the ensuing years, the nature of trading on ECMs has changed, offering central counterparty clearing for transactions executed on the ECM, expanding the breadth and depth of market participants, attaining increased trading volumes, and offering contracts that either look like, or settle to prices of, contacts traded on DCMs.

In light of this evolution in the market structure of many ECMs, Congress recognized that certain of the contracts traded on ECMs, contributed to, or affected the price discovery process of certain contracts traded on designated contract markets or effectively had themselves become venues for price discovery. The Reauthorization Act imposes a higher level of regulatory oversight over these contracts, termed "Significant Price Discovery Contracts." Specifically, it increases reporting requirements and market transparency for SPDCs and imposes on the markets on which they trade a number of self-regulatory responsibilities. The Commission's proposed rules implement this Congressional mandate.

The Proposed Rules in General

If the Commission determines a contract to be an SPDC, the proposed rules would impose a number of new regulatory obligations on the ECM. They include:

- Certifying terms and conditions of SPDCs;
- Monitoring trading to prevent market manipulation and participant abuses;
- Establishing position limits or position accountability rules;
- Providing for exercise of emergency authority;
- Enhancing transparency by publicly reporting certain information and trading data;
- Monitoring and enforcing compliance with market rules; and
- Minimizing conflicts of interest in decision making.

MFA commends the Commission for its close adherence to the spirit and the letter of the Reauthorization Act in proposing these implementing rules. Both the procedural and substantive rules, as proposed, are straightforward and well thought-out.

As the Commission notes in its discussion of the proposed rules, the Reauthorization Act significantly broadens the Commission's authority over ECMs having SPDCs by including such markets within the Act's definition of "registered entity."[6] The Reauthorization Act thereby brings such markets within many of the procedural and substantive provisions of the Act that also

---

[5] *See* Commodity Futures Modernization Act of 2000, (Appendix E of P.L.106-554, 114 Stat. 2763).

[6] SPDC Proposed Rules at 75891.

apply to DCMs and registered derivatives clearing organizations. The Commission in its proposed implementing rules has followed this lead, weaving the rules applicable to ECMs having SPDCs into the fabric of the existing regulatory framework wherever possible. Even where the Commission has crafted new rules applicable only to ECMs having SPDCs, it appears to have been guided by the existing practice and requirements that apply to registered entities.

MFA applauds this approach both philosophically and as a practical matter. We note that to the extent that certain contracts will meet the criteria to be considered to be SPDCs on the basis that they are economically linked to contracts traded on DCMs, it makes sense that the regulatory scheme that applies to both a DCM and an ECM should be as consistent as possible. This has the benefit of eliminating or minimizing regulatory arbitrage as a motivating factor in the decision of a market participant to trade on a designated contract market or on the ECM having the related SPDC.

Moreover, many of our members are likely to participate in a number of markets, including both ECMs having SPDCs and DCMs. Commission rules that are similarly applied across as many markets as possible creates an environment that assists our members' compliance efforts. Consistency of rules reduces the complexity of internal compliance programs, creating greater efficiency in their implementation and operation. More importantly, consistency of rules from one market to another increases our members' ability to ensure that their internal compliance programs are constructed to maximize their effectiveness. Finally, consistency of rules between different markets on which economically linked contracts are traded reduces the opportunity for participants in both markets to be subject to unintended economic distortions that may be a consequence of differences in the manner in which regulatory requirements are applied to the two markets.

For these reasons, MFA supports integrating the rules relating to ECMs having SPDCs with the rules that apply to other registered entities to the greatest degree possible. Our comments on specific rules proposed by the Commission suggest changes that would align the rules which apply to ECMs having SPDCs more closely with the rules that apply to DCMs or other registered entities. These suggestions all relate to rules that the Commission has proposed to implement Core Principle IV, which requires ECMs having SPDCs to establish speculative position limits or position accountability rules. Our specific comments are as follows:

1. Position Accountability Rules

As noted above, the Reauthorization Act applies a number of Core Principles to ECMs having SPDCs. New Core Principle IV requires the ECM to "adopt, where necessary and appropriate, position limits or position accountability for speculators, taking into account positions in other agreements, contracts and transactions treated by a derivatives clearing organization, whether registered or not registered, as fungible with such significant price discovery contracts to reduce the potential threat of market manipulation or congestion." In applying the Core Principles, the Reauthorization Act permits the ECM to "have reasonable discretion (including discretion to account for differences between cleared and uncleared significant price discovery contracts)."

We believe the Commission's proposed rules implementing Core Principle IV with respect to position accountability rules for an ECM with a SPDC should be brought into closer alignment with its Guidance on Acceptable Practices relating to position accountability rules for DCMs.[7]

First, the Commission should take care to differentiate the *inquiry* that a market conducts when a trader crosses a position accountability level from an "investigation." When an accountability level is breached, a market's surveillance staff will routinely inquire as to the nature of the trader's position and whether it raises any market concerns. This inquiry is understood under current contract market practice to be a routine review of the trader's position and strategy which is occasioned by the trader exceeding the position accountability level. The Commission's guidance on Acceptable Practices for designated contract markets does not refer to this review as an "investigation." That term is more commonly understood as relating to a proceeding brought in connection with a possible rule violation. In this context, due diligence questionnaires submitted to commodity pools by potential investors often ask whether the pool has been the subject of an investigation. An affirmative response may render the pool ineligible to receive an investor's funds. We therefore urge the Commission to appropriately distinguish between a "market surveillance inquiry" with respect to a position which exceeds a position or volume accountability level and an "investigation" of a rule violation.

In addition, the proposed Guidance on Acceptable Practices directs that the ECM "should initiate" such an inquiry once a trader exceeds a position accountability level.[8] This departs from, and is far more prescriptive than, the Guidance for Compliance with Core Principles for Contract Markets.[9] DCMs are not mandated to conduct an inquiry in response to every breach of a position accountability level. Rather, DCMs have the discretion to determine whether to open an inquiry in particular cases. A DCM may base its determination on a number of factors, including the size of the position and the over-all condition of the market. This discretion enables DCMs to concentrate their surveillance efforts on those instances which appear to raise serious or sustained market concerns. MFA respectfully suggests that providing similar discretion to ECMs will enable them to conduct more effective market surveillance by concentrating their resources on only those breaches that are significant, that involve traders who are departing from familiar trading patterns or who are unknown to the market, or that are sustained in nature.

Second, with respect to Core Principle IV in its Guidance On, and Acceptable Practices in, Compliance with Core Principles, the Commission proposes that an ECM set non-spot individual month and all-months-combined position accountability levels for contracts that are not economically equivalent to an existing contract at "10 percent of the average combined futures and delta-adjusted option month-end open interest for the most recent calendar year.[10] We respectfully urge the Commission to reconsider this requirement.

The 10% of open-interest measure is not applied to contract markets. Rather, the requirement for contract markets is open-ended, leaving the determination of the appropriate level

---

[7] The Commission's Guidance on Acceptable Practices with respect to Core Principle 5 for designated contract markets is found at 17 C.F.R. Part 38, Appendix B, Core Principle 5(b).

[8] 73 *Fed. Reg.* at 75916.

[9] *Compare* 73 *Fed. Reg.* at 75916 and 17 C.F.R. Part 38, Appendix B, Core Principle 5(b)(3).

[10] 73 *Fed. Reg.* 75916.

to the surveillance experience and judgment of the contract market. MFA believes that this more flexible approach is also appropriate for an ECM with a SPDC.

However, even if the Commission determines that it should provide more detailed guidance to an ECM than to a DCM on setting position accountability levels, a more nuanced and flexible approach is still necessary. For example, simply referring to 10% of the average combined futures and delta-adjusted option month-end open interest will not necessarily apply to contracts traded on an ECM. And, for a unique SPDC, there may be no contract market on which linked futures and options are traded. In that case, the position accountability or (non-spot month speculative position limit level) would have to be set based upon trading in a contract, agreement or transaction subject to the provisions of section 2(h)(3) of the Act.

Moreover, as the Commission notes elsewhere in its proposal, trading on ECMs in SPDCs may include cleared and uncleared contracts. Accordingly, a 10% formula relating to month-end open interest, unless it includes both cleared and uncleared contracts, may understate the size of the market and thereby lead to an artificially low position accountability level. In this regard, the Commission notes in its *Federal Register* release that the position accountability level is intended to be set at levels that "capture a material amount of large positions that could threaten the market."[11]

Accordingly, MFA strongly suggests that the Commission consider providing guidance on setting the level of non-spot position accountability rules that each ECM can tailor to the market in its unique SPDCs. It may be that this is best accomplished by providing a list of criteria, including for example, the depth and liquidity of the related cash market, whether there are constraints on delivery of the commodity, whether the SPDC is financially settled or physically delivered, the liquidity and depth of trading on the ECM, the relative volume of cleared and uncleared transactions on the ECM and whether in light of those factors, the position accountability level would be triggered by a position that is large enough to pose a potential threat to orderly trading or contract liquidations of the SPDCs. MFA believes that this type of multi-factor test will best enable an ECM to propose position accountability or non-spot month speculative position limit levels which are better tailored to the characteristics of the market and to the particular unique SPDC.

2. Volume Accountability Rules

In implementing Core Principle IV's requirement that the ECM adopt position limits or position accountability rules, the Commission also proposes to create an entirely new regulatory category—volume accountability limits—which would apply only to uncleared transactions in SPDCs. This new category would increase operational complexity by requiring separate accounting for such positions, possibly with a different and unique set of metrics.

More critically, speculative position limits and position accountability levels are calculated on the basis of a trader's net long or net short position. In its release, the Commission recognizes the role that netting plays in complying with a position limitation, but focuses solely on netting of transactions in uncleared SPDCs with the same counterparty.[12] However, it is

[11] 73 Fed. Reg. 7586.

[12] 73 *Fed. Reg.* at 75896.

equally likely that traders may enter into a cleared SPDC that off-sets the economic risk of an uncleared SPDC transaction. This would be a classic use of the markets for hedging. Creating a separate limit category for uncleared contracts would impede a trader's ability to reflect the true net economic exposure of the position in relation to either the volume accountability level or to the speculative position limit. This creates the possibility that traders will be found to violate either, or both, levels when the size of the net position would be less than that if the level were unified.

It could be argued that because exceeding a volume accountability level merely would result in an inquiry during which the trader would be able to demonstrate any economically off-setting positions, the fact that separate limits may result in more frequent breaches of the level is not a significant concern. However, even though the inquiry initiated when a level is breached is not an investigation into a possible violation of a Commission or market rule, traders may nevertheless refrain from taking positions that would innocently exceed the rules in order to ensure that they remain in compliance.

This would have the result of chilling legitimate trading activities and perhaps encouraging trading to be effectuated in the bi-lateral markets and away from an ECM. This possibility should be avoided, particularly when a unified level for cleared and uncleared trades would reduce the number of unwarranted inquiries. The Commission has grappled with this issue previously, opting to move from separate speculative positions for futures and options to a unified level for both.[13] For these reasons, MFA recommends that the Commission incorporate SPDCs into the existing regulatory framework for speculative position limits and position accountability levels rather than create an entirely new and separate limit category.

3. Grace Periods

The Commission is proposing to permit a grace period with respect to implementation of speculative position limits or position accountability levels when contracts are initially determined to be SPDCs. The Commission proposes to require traders to "become compliant with applicable position limit rules . . . no later than 90 calendar days from the date of the ECM's implementation of position limit rules, unless a hedge exemption is granted by the ECM."[14] MFA agrees with the Commission's recognition that fairness requires a means of transitioning to the new position limits where limitations did not previously exist. However, rather than creating a new grace period rule applicable only to SPDCs, MFA urges the Commission to rely upon the existing statutory and regulatory framework with respect to such transitions.

Section 4a(b)(2) of the Act provides that when the Commission sets speculative position limits, "such position limits shall not apply to a position acquired in good faith prior to the effective date of such rule, regulation, or order." The Commission has applied this standard to exchange-set speculative position limits as well.[15]

---

[13] *See* Commission Rule 150.2 providing that calculation of speculative positions includes options positions on a "futures-equivalent basis."

[14] 73 Fed. Reg. 75896.

[15] See 17 C.F.R. §150.5(f).

In applying this good faith standard, the Commission has allowed positions that exceed a newly imposed or adjusted level at the time that the new level becomes effective to be maintained at that level until liquidated. Absent an exemption, as the position declines it may not be increased so long as it remains above the new level. Once falling below the new or adjusted level, the new level will control. MFA believes that the Commission should apply this transition rule to SPDCs as well.

We believe using the same rule for transitioning to new or adjusted limits for all markets eases the complexity of compliance. More importantly, establishing different rules for markets that may be economically linked could cause price dislocations or distortions. For example, if a trader has spread positions across an economically linked ECM and a DCM and the rules between the two differ with respect to transitioning to new or adjusted limits, rather than reducing both positions gradually in a balanced way, the trader might reduce the positions at an unequal rate, possibly having unintended, but detrimental market effects. Moreover, SPDCs may be of longer duration than typical for contracts traded on DCMs. Traders may suffer undue losses if they are required to reduce positions within 90 days, particularly where the market may be less liquid for such long-dated contracts. Accordingly, MFA recommends that the Commission amend the proposed grace period requirement to align with, and conform to, the transition rule applicable generally to the imposition of new or adjusted speculative position limits.

* * * * *

MFA applauds the Commission's proposed rules implementing the Reauthorization Act with respect to Significant Price Discovery Contracts. We support the Commission's approach of integrating rules for Exempt Commercial Markets trading Significant Price Discovery Contracts with those that apply to trading on other registered entities to the greatest degree possible. As discussed above, we believe that there are a number of requirements relating to Core Principle IV that could be more closely attuned to the existing regulatory framework. MFA believes that these changes will increase the consistency of the Commission's rules, reduce complexity, ease compliance and reduce the possibility of regulatory arbitrage.

We would be happy to discuss our comments or any of the issues raised by the proposed rules at greater length with the staff. If the staff has questions or comments, please do not hesitate to call Jennifer Han or the undersigned at (202) 367-1140.

Respectfully submitted,

Richard H. Baker
President & Chief Executive Officer

cc: Acting Chairman Dunn
Commissioner Lukken
Commissioner Chilton
Commissioner Sommers
Terry Arbit, General Counsel
Richard A. Shilts, Director DMO
Susan Nathan, Senior Special Counsel
Paul Architzel, Alston & Bird LLP