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NFA NATIONAL FUTURES ASSOCIATION

June 16, 2009

COMMENT

Via E-mail: secretary@cftc.gov
Mr. David Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Whether to Eliminate the Bona Fide Hedge Exemption for Certain Swap Dealers and Create a New Limited Risk Management Exemption from Speculative Position Limits

Dear Mr. Stawick:

National Futures Association ("NFA") appreciates the opportunity to comment on the Commission's concept release regarding the bona fide hedge exemption for swap dealers. At the outset, NFA recognizes that one of the CFTC's paramount regulatory concerns is market integrity and the CFTC's regulatory approach has long fostered markets that reflect the forces of supply and demand for an underlying commodity, and that are free of abusive and manipulative trading activity. In implementing this regulatory approach, the Commission has successfully relied upon certain basic tools—the use of speculative position limits and position accountability provisions, certain exemptions from the limits, and an aggregation policy applied to commonly owned or controlled accounts. In addition, Commission market surveillance staff assess an individual trader's activities, potential market power, and enforce speculative position limits by using a large trader reporting system, which is critical to the Commission's reliance on the other tools.

NFA also recognizes that the Commission last made amendments to the exemptive rules in 1991, nearly twenty years ago. Given significant changes in market participants, trading patterns and practices in the derivatives market, NFA also applauds the Commission for undertaking a review of these exemptive rules at this time. NFA understands that in undertaking this review the Commission is concerned that noncommercial counterparties may be purposefully evading the oversight and limits of the CFTC and exchanges by amassing speculative OTC positions in energy and agricultural commodities that distort prices in the futures market and undermine its price discovery function.

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Of course, an analysis of market data is critical to any determination as to whether certain market participants have amassed these types of OTC positions. In 2008, the Commission took a very methodical approach in collecting and analyzing market data relating to energy and agricultural OTC positions. In particular, in June 2008, the Commission issued a special call to swap dealers and index traders seeking information on the types of end-user clients trading over-the-counter commodity transactions with swap dealers and the extent to which these clients hold aggregate positions that would exceed position limits or accountability levels if converted to on-exchange futures equivalent positions. The Commission staff's report on Commodity Swap Dealers and Index Traders ("Staff Report") found that although some non-commercial traders appeared to have an aggregate position that would have exceeded position limits or accountability levels if converted to futures equivalent positions, these amounts were negligible in comparison to the overall size of the futures market in the particular commodity. The Staff Report was based on data collected for the time period December 31, 2007 through June 30, 2008.

Despite the Staff Report's findings, NFA believes that the Commission cannot be complacent and that the current review of its exemptive rules is commendable. While NFA recognizes that the Commission's 2008 special call continues today, NFA strongly recommends that the Commission make clear that this special call will be a permanent tool utilized by the Commission. The call permits the Commission to obtain a more complete picture of the interplay between on-exchange and over-the-counter transactions and the effect, if any, on price discovery. By obtaining and analyzing information obtained over a longer period of time, the Commission may be in a better position to craft a more precise, effective, and comprehensive regulatory scheme. To that end, NFA recognizes that the Commission has been collecting special call data since June 30, 2008 and we encourage the Commission to release its analysis of this longer-term data, and determine whether findings from this analysis are consistent with the 2008 Staff Report or alter the Staff Report's findings and recommendations.

In proposing changes to exemptive rules that have been in place for approximately twenty years, NFA urges careful analysis and extreme caution. The creation of a new risk management exemption certainly would alter the manner in which swap dealers manage their risk, which could also have an impact upon the risk management capabilities of their noncommercial and commercial clients. If a new risk management exemption proves unduly burdensome, swap dealers may be less willing to participate in the swap market thereby limiting the ability of OTC market participants to manage their risk and protect against price volatility. Additionally, if swap dealer activity declines, then their corresponding need to participate and hedge in the futures markets may also significantly diminish leading to less liquidity and increased price volatility. In the worst case, swap dealers may engage in OTC swaps but simply elect not to use the futures markets to offset their risk, which may raise significant systemic risks.

NFA believes that a hasty decision that eliminates hedge exemptions for swap dealers may not only do great harm but could also be rendered moot by other regulatory initiatives. In particular, given the current interest in regulating OTC derivatives, NFA encourages the Commission to ensure that any proposed changes to the swap dealer hedge exemption be consistent with other changes to the regulatory structure for OTC derivatives. As you are aware, during the last two years, various Senators and Congressmen have proposed a number of bills that would restrict hedging, impose speculative and aggregate position limits, increase transparency, and/or require the Commission to conduct studies. Additionally, on May 13, 2009, the Commission, the Department of Treasury, and the SEC jointly announced a proposed comprehensive regulatory framework for OTC derivatives that calls for the clearing of standardized transactions. This framework, recently supported by CFTC Chairman Gensler's June 4, 2009 Congressional testimony, also includes robust reporting requirements imposed upon dealers and calls for the Commission to set aggregate position limits, including OTC derivatives. Given the outline of this framework and, in particular, its emphasis upon aggregate position limits, we strongly recommend that the Commission coordinate its own review of its exemptive rules with any future legislation proposed by the Administration and Congress.

The fact remains that a legislative proposal may not be finalized for several months. Therefore, NFA favors the development of an interim tool—a reporting system for end-user positions of all OTC contracts that relate to a physical commodity traded on a regulated futures market, analogous to the current large trader reporting system in place for futures positions. The development of this system will not cause any of the potential dire market consequences described above relating to tampering with swap dealer hedge exemptions and will not be rendered moot by future regulatory initiatives. It will, however, add significantly greater transparency to end-user trading activity and bolster public confidence in the markets.

Under this approach, each swap dealer would have an obligation to report to the Commission when a commercial or noncommercial end-user's open OTC positions reach a certain level in terms of futures equivalent positions. NFA believes that this type of reporting system would allow the CFTC to track open positions of OTC end users and to evaluate what, if any, market impact these positions may have upon the futures markets. Based upon this information, the Commission may determine that it needs to take appropriate action if it found that noncommercial end-users have purposefully evaded the oversight and limits of the CFTC and exchanges by amassing an OTC position in energy and agricultural commodities that distorts prices in the futures market and undermines its price discovery function.

In conclusion, NFA appreciates the opportunity to comment on this extremely important issue. We believe that our recommendations, if adopted, will provide increased transparency to OTC market activity and guard against potential market abuses. Additionally, these measures will provide the Commission with critical information regarding noncommercial end-user activity and allow the Commission time to further study this issue based upon additional data collection. Lastly, as previously stated, NFA strongly recommends the Commission coordinate its own review of its exemptive rules with any future legislation proposed by the Administration and Congress.

Respectfully submitted,

Thomas W. Sexton
Senior Vice President and
General Counsel

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