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COMMENT

Received CFTC
Records Section
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July 13, 2009

Mr. David Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Commodity Futures Trading Commission's ("CFTC" or "Commission") Concept Release on Whether to Eliminate the Bona Fide Hedge Exemption for Certain Swap Dealers and Create a New Limited Risk Management Exemption from Speculative Position Limits ("Concept Release")

Dear Mr. Stawick:

Steel Manufacturer's Association ("SMA") and East Texas Electric Cooperative ("ETEC"), (collectively referred to as "SMA and ETEC") submit this letter in response to the CFTC's request for comments that appeared in 74 Fed. Reg.12282.

The members of SMA and ETEC regularly enter into power purchase agreements and hedges, which are largely or directly based on the price of natural gas. ETEC and its members regularly execute physical and financial natural gas transactions. The members of SMA and ETEC are substantially affected by disproportionate financial "investment" in natural gas commodities to the extent that such investment creates periods of excessive prices and increased volatility. SMA and ETEC take this opportunity to respond to the Concept Release Question No. 4:

4. The existing bona fide hedge exemptions granted by the Commission extend only to those agricultural commodities subject to Federal speculative position limits. Should the interpretation of bona fide hedging and any new limited risk management exemption extend to other physical commodities, such as energy and metals, which are subject to exchange position limits or position accountability rules?

SMA and ETEC strongly support the extension of position limits and implementation of the proposed limited risk management exemption to natural gas commodities. SMA and ETEC also request that the CFTC reconsider no-action relief that exempts commodity index funds from application of position limits.[1]

[1] CFTC Letters 06-09 (May 5, 2006) and 06-19 (September 6, 2006).

To the extent that exchange traded securities, commodity notes, hedge funds, pension funds and similar investment vehicles ("Funds') cause natural gas prices to diverge from fundamental valuation and generate excessive volatility, such speculation should be limited. SMA and ETEC believe that reasonable position limitations would provide for continued liquidity while reducing the influence of these financial investments on commodity prices.

In markets where position limits apply and prevent participants from excessive speculation, associated hedge exemptions provide the valuable function of exempting swap dealers from these position limits to the extent that they make markets for parties that hedge risk.[2] For example, if a fabric manufacturer seeks to hedge the cost of cotton, and executes a cotton swap with a dealer, the dealer can apply for a hedge exemption to hedge the swap's risk in the futures market, and avoid breaching position limits. Otherwise, the particular commodity exchange limits the extent to which the dealer can speculate on cotton through application of position limits. The combination of position limits and hedge exemptions reasonably limit speculative activities while fostering robust commercial hedging programs.

Unfortunately, the hedge exemption can be applied in a manner that allows for certain forms of speculation. Funds that seek large speculative positions can rely on a dealer's hedge exemption to effectively launder their speculative positions, circumventing position limits. This occurs because an exchange's inquiry into position limits primarily relates to the dealer's position and not that of the counterparty seeking the hedge.[3] In this manner, Funds that speculate on commodity prices benefit from a tool designed to enable commercial hedging, but which was intended to limit speculation.[4] Along with the growth and development of Funds in recent years, commodity prices and volatility have similarly risen, sometimes to extraordinary levels.

Dealer-based hedge exemptions enable Funds to trade without position limits, while position limits restrain dealers and any other direct market participant from excessive speculation. Funds are limited in speculating only to the extent of their credit limit with each dealer. The opaque actions of Funds, shrouded through indirect transactions with dealers, inappropriately provide cover from hedge exemptions while most others market participants are subject to limits. This disparity supports the notion that the hedge exemption is misapplied.

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[2] *See* 17 CFR 38, Appendix B, Core Principle 5.

[3] Rule Enforcement Review of the New York Board of Trade, CFTC, Division of Market Oversight at p. 14 (October 26, 2005).

[4] *See* 17 CFR 38, Appendix B, Core Principle 5.

If the CFTC implements the proposed limited risk management exemption, this would look through the dealer to consider the position of the counterparty to the dealer, bringing those parties within the reach of position limits.

Currently, the CFTC does not directly apply position limits to natural gas products. The NYMEX, with regard to its natural gas products, oversees contract positions and generally only limits position sizes as contracts approach expiration. SMA and ETEC request the CFTC to extend application of position limits to natural gas commodity products and implement the proposed limited risk management exemption for natural gas commodities. The proposed limited risk management exemption should place reasonable limits on the extent to which Funds could trade through dealers to speculate on commodities.

The need for this expansion of CFTC oversight arises due to the sophistication of fund managers and the breadth of financial "investment" in natural gas commodity products. The CFTC needs the ability to aggregate positions of specific non-commercial market participants across all exchanges that make substantial markets in natural gas. Without this ability, speculative traders with outsized positions will shift into markets where they have yet to reach a position limit, or to a market that has no limit at all. All exchanges that maintain a significant market share of the natural gas commodity should be subject to these limitations.

Gaming across exchanges, or the intention to do so, was made patently clear when *Platts Gas Daily* reported the comments of John Hyland, the portfolio manager and chief investment officer of United States Natural Gas Fund, LP ("UNG"),[5] on May 22, 2009. The natural gas newsletter reported that "Hyland told Platts earlier this week that if NYMEX asked the fund to reduce its percentage of open interest, it could move positions to ICE."[6] For these reasons, ICE Henry Hub natural gas products should also be subject to position limits and proposed limited risk management exemption rules.

Recent trading activity in UNG created concerns for SMA and ETEC regarding excessive speculation. The explosion in UNG volume that started in April 2009 and peaked in June correlated well with excessive volatility and price increases. The hedging

[5] *See* UNG Prospectus (May 6, 2009). UNG is a commodity pool and an exchange traded security. The investment objective of UNG is to have the changes in percentage terms of the units' net asset value reflect the changes in percentage terms of the price of natural gas delivered at the Henry Hub, Louisiana, as measured by the changes in the price of the futures contract on natural gas traded on the New York Mercantile Exchange that is the near month contract to expire, except when the near month contract is within two weeks of expiration, in which case it will be measured by the futures contract that is the next month contract to expire, less UNG's expenses.

[6] NYMEX keeping eye on heavily traded gas fund, Platts Gas Daily (Platts), May 22, 2009 p. 7.

associated with these exchange traded security volumes represents a significant portion of both ICE and NYMEX open interest.[7] Trading activity during this period reversed a period of decline in the natural gas markets, despite continued fundamental weakness -- record storage, strong production and substantial excess production capacity.

We understand that the CFTC is indirectly looking into this issue, in part, under its review as described in 74 Fed. Reg. 28028 to determine whether the Henry Financial LD1 Fixed Price contract traded on the ICE performs a significant price discovery function. SMA and ETEC support that review and a finding that LD1 is a Significant Price Discovery Contract ("SPDC'). Recognition of LD1 as an SPDC would enable application of position limits on LD1 transactions on ICE. SMA and ETEC are also filing under that request for comment.[8]

This UNG activity provides a textbook case on the ability of a single commodity "investment" product to impact the price of natural gas on the NYMEX and ICE. On July 9, 2009, *Platts Gas Daily* reported rather dramatic comments by traders relating to the Security and Exchange Commission's ("SEC") failure to approve the UNG's issuance of more shares:[9]

> The fund, which warned in a Securities and Exchange Commission filing Monday that it faced running out of registered units if the SEC did not approve its June 5 new-registration request, did just that Tuesday, leading the New York Stock Exchange to order a 45-minute trading halt for UNG while the fund provided the SEC more information. Several traders noted an immediate drop in the August NYMEX gas futures contract, which slid 8.2 cents in the last hour of trading. "You saw such a bearish reaction immediately," a Houston-based NYMEX trader said. "Big black box funds are ready to start arbitraging this."
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> Speculation of another large drop Wednesday materialized to some degree as the contract closed another 7.6 cents lower… [Sempra's Brison] Bickerton said the halt of new capital into UNG could have a longer-term bearish effect on prices. "Getting a 7-cent sell-off despite weather maps that are a little bit warmer is impressive. It says that the market is selling off in the face of UNG." Stephen Schork, president of Schork Group, agreed, saying he believes the lack of new money will have a bearish effect on gas prices. "Wall Street has been selling [UNG] since the winter, and the clients don't have much to show for it so far. Perhaps this is the breather they need to step back and realize just because a commodity is

[7] *Id.*

[8] Notice of Action and Request for Comment, 74 FR 28028 (June 12, 2009).

[9] Traders watch NYMEX for sign of gas fund's impact, Platts Gas Daily (Platts), July 9, 2009 p. 3.

> cheap doesn't mean it has to get expensive," Schork said. "If we take out this lift that UNG could have been providing the market, you could very well see this flush down below $3."
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> A recent report from Credit Suisse said the vacuum created by UNG's sudden absence would lead to continued downward pressure on prices, and that many UNG investors may take this opportunity to divest themselves. "That bid is going to be missing from the futures market now. You've filled up a bag and you can't put any more in it. It's a very bearish dynamic," a Houston based NYMEX trader added.
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> But according to Bickerton, the real impact will come when the SEC makes a ruling on whether UNG gets its new units. "It could spark a major short-covering market," Bickerton said. "If the market postulates that big volumes are on the way, you [might] have a rip-your-face-off short-covering rally. It's kind of a scary thought."

These comments, in summary, indicate that the lack of additional gas purchasing by UNG, due to SEC restrictions, generated significant bearish sentiment, and caused natural gas prices to fall substantially, presumably toward price levels dictated by market fundamentals. If the SEC later determines it would permit the issuance of additional UNG shares, there is a risk of a large short covering rally, as the issuance brings UNG back to market.

If the comments of the various market participants in the excerpt above are accurate, the UNG exchange traded security created excessive volatility and temporarily increased prices above levels suggested by economic fundamentals. Based on the above, whether investors in UNG consisted of sophisticated funds, or a herd of individual investors, these financial investors significantly impacted natural gas prices.

In addition to the current lack of CFTC based position limits on exchange traded natural gas commodity products, UNG benefits from CFTC no-action letters that indicate the CFTC will not subject commodity pools similar to UNG to position limits.[10] Based on impact of UNG, SMA and ETEC also request the CFTC to reconsider this exemption from position limits.

In summary, the CFTC should extend application of position limits, and implement the proposed limited risk management exemption for natural gas commodity contracts to enable the CFTC to aggregate positions of specific non-commercial market participants across all relevant exchanges and prevent excessive speculation from creating market dislocations. Due to the apparent excessive impact of UNG on the price of natural gas, and for consistency and equity, the CFTC should also reconsider no-action

[10] *See* CFTC Letters 06-09 (May 5, 2006) and 06-19 (September 6, 2006).

relief granted, which currently exempts commodity index funds and securities from position limits.

Sincerely,

Peter Haller

Peter G. Haller
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