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June 16, 2009

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

Re: *Concept Release on Bona Fide Hedge Exemption, 74 Fed. Reg. 12282 (March 24, 2009)*

COMMENT

Dear Mr. Stawick:

The Futures Industry Association welcomes this opportunity to submit these public comments on the Commission's above-referenced concept release published in the *Federal Register* on March 24, 2009. The Commission's concept release highlights significant regulatory issues relating to the Commission's essential statutory mission: to promote and preserve the integrity of the price discovery function performed by the futures markets. At its core, the Commission's concept release raises fundamental issues concerning the relationship of certain over-the-counter derivatives transactions to the futures market price discovery process.

FIA Position Summary.

FIA has always strongly supported efforts to provide the Commission with all necessary market surveillance tools as well as appropriately administered speculative position limits to prevent price manipulation or price distortion in the futures markets.[1] Preserving the integrity of futures prices is essential to enabling the futures markets to continue to serve the congressionally-identified national public interests in hedging, price discovery and price dissemination (7 U.S.C. § 5(a)).

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[1] FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 30 of the largest futures commission merchants ("FCMs") in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

FIA does not believe that revoking the so-called swap dealer hedge exemption or adopting the limited risk management exemption as proposed in the staff's September 2008 Report would be sound public policy. Neither action would serve to promote or secure the integrity of the price discovery process. Dealer futures positions are routinely and transparently reported to the Commission under its Large Trader Reporting System. The concept release cites no evidence that these dealer futures market positions have ever harmed the integrity of futures market prices by creating artificial prices or price distortions of any kind. Yet revoking the dealers' hedge exemption raises the dangerous prospect of shrinking the common understanding of what is hedging in futures markets which could cause a broad swath of businesses to eschew hedging price risks in regulated futures markets. Those businesses would then be forced either to assume the price risks they could not hedge (in effect speculate on those price risks) or increase the use of OTC instruments directly to manage their price risks. In addition, the recommended limited risk management exemption would be unworkable and could actually distort the transparency of the Commission's market surveillance process.

Instead of undertaking a proposed rulemaking on the measures outlined in the concept release, FIA recommends that the Commission consider a new rulemaking that would focus on the extent to which, if any, certain OTC derivatives perform a significant price discovery function for regulated futures markets and what form of additional Commission regulation, if any, would be appropriate for market surveillance purposes. In that connection, the Commission may want to consider regularizing the monthly reporting process now conducted under the Commission's special call authority. This approach would be consistent with the regulatory reform legislation that is expected from President Obama's Administration according to statements from Treasury Secretary Timothy Geithner and Commission Chairman Gary Gensler as well as proposals already pending in Congress. Given the Commission's experience with the data of OTC derivatives it has captured through its special call process, a Commission rulemaking could be easily based on actual market experience and analysis of market positions rather than rhetoric and supposition. This rulemaking also could be combined with the Commission's announced plan to conduct a new rulemaking on how best to address uncleared significant price discovery contracts. See 74 Fed. Reg. 12178, 12181 (March 23, 2009).

The Importance of Speculation.

FIA agrees with the Commission that futures market prices must be protected from price manipulation and other distortions. The integrity of the price discovery process is the primary force that allows businesses worldwide to rely on futures market prices as a reference point for commercial transactions and to hedge their price risk efficiently. Speculators play an essential role in the price discovery process to ensure properly functioning futures markets. Without speculators to assume the price risks that hedgers seek to avoid, futures market prices would be so volatile and unpredictable that the markets would be unable to serve the public interest in providing efficient price risk management and reliable benchmark prices. Protecting

this dual goal of risk management and price discovery is at the core of the Commission's mission under the CEA.

Congress itself has explicitly recognized the important role speculation plays by assuming price risks in liquid trading markets. In Section 3(a) of the CEA, Congress found that

> "The transactions subject to this chapter are entered into regularly in interstate and international commerce and are affected with a national public interest by providing a means for managing **and assuming price risks**, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities."

(7 U.S.C. § 5(a) emphasis added). Thus, Congress has found that by assuming the price risk hedgers seek to avoid and by providing liquidity, speculative trading in the futures markets actually serves the public interest.

Statutory and Regulatory Background of Position Limits.

While Congress has recognized the vital role of speculation, Section 4a(a) of the CEA also authorizes the Commission to impose daily trading limits and speculative position limits for the purpose of "diminishing, eliminating or preventing" what the statute defines to be the burdens of excessive speculation: "causing sudden or unreasonable fluctuations or unwarranted changes" in the price of a regulated futures contract. 7 U.S.C. § 6a(a). The statute further makes it unlawful for any person, directly or indirectly, to exceed any daily trading limit or any speculative position limit imposed by the Commission. 7 U.S.C. § 6a(b). However, by law, none of these Commission limits applies to bona fide hedging transactions or positions as defined by the Commission. 7 U.S.C. § 6a(c).

Under this statutory authority, the Commission has set speculative position limits for certain agricultural commodities (17 C.F.R. § 150.2) and exempted from those requirements bona fide hedge transactions as defined in 17 C.F.R. § 1.3(z). The Commission has delegated the authority to set position limits in other commodities to designated contract markets, which must meet Core Principle #5 by adopting, as necessary and appropriate, position limits or accountability levels for speculators. 7 U.S.C. § 7(d)(5). Designated contract markets have adopted hedge exemptions from these requirements as appropriate. Both the Commission and the DCMs enforce these requirements.

Swap Dealers and the Hedge Exemption.

The September 2008 Commission Staff Report summarized certain aspects of the activities of swap dealers and how these activities are regulated, including the hedge exemptions the dealers have received.

> "The swap dealer, which is often affiliated with a bank or other large financial institution, has emerged to serve as a bridge between the OTC swap market and the futures markets. Swap dealers act as swap counterparties both to commercial firms seeking to hedge price risks and to speculators seeking to gain price exposure. In essence, swap dealers function as aggregators or market makers, offering contracts with tailored terms to their clients before utilizing the more standardized futures markets to manage the resulting risk."

Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations (Sept. 2008) ("CFTC Staff Report"), p. 1.

Beginning in 1991, the Commission granted hedge exemptions to swap dealers to the extent that they use futures markets "to manage the price risk on their books that results from serving as a market maker to OTC clients." *Id.* The available evidence supports the rationale for the dealers' hedge exemption. Based on an analysis of special call data received from swap dealers, the CFTC staff concluded: "[F]utures market trades by swap dealers are essentially an amalgam of hedging and speculation by their clients. Thus, any particular trade that a swap dealer brings to the futures market may reflect information and decisions that originated with a hedger, a speculator, or some combination of both." CFTC Staff Report at 1-2.

Some have claimed that the Commission's hedge exemption for swap dealers has been misused to allow market participants to violate position limits indirectly. Under this theory, market participants cause higher commodity prices by entering into OTC swap transactions with dealers who then establish corresponding positions in the futures markets. In effect, it is alleged that swap dealers are acting as conduits to mask excessive long speculative positions in futures markets.

This allegation is contradicted by the CFTC staff findings quoted above and, in FIA's view, misapprehends the Commission's current dealer exemptions. Any dealer whose principal or exclusive purpose is to collude with its swaps counterparty to evade position limits would not, and should not, be entitled to a hedge exemption. But there is no evidence that swap dealers generally engage in that misconduct as the Commission's extensive special call data over the last year has revealed and as the CFTC Staff Report's findings show. Instead, dealers enter into OTC swap transactions with counterparties and then offset the price exposure they assume

from those transactions internally through swaps with other counterparties and other dealers. Dealers then hedge only their net price exposure on the futures market and therefore only that net price exposure has contributed to the futures price discovery process.

The Commission's Stated Rationale for Revoking the Hedge Exemption.

The Commission has never expressed any concern that the swap dealers' futures trading is harming price discovery in the futures markets. Instead, the Commission's stated basis for considering whether to revoke the dealer hedge exemption rests on just two points. First, the allegation that some of the swap dealers' counter-parties may be "purposefully evading the oversight and limits of the CFTC and exchanges." 74 Fed. Reg. 12285-86 (March 24, 2009) Second, the Commission wants to ensure that "manipulation is not occurring outside of regulatory view." Id. Neither concern is rationally related to the dealers futures trading itself, let alone related to revoking the dealers' hedge exemption.

Swap dealer futures trading does not evade CFTC and exchange oversight. On the contrary, like all other futures hedge positions, it is fully transparent and reported daily to the CFTC and exchanges, as required by law. Dealer futures trading therefore could not be part of a manipulation that is occurring outside the Commission's regulatory view. Instead dealer futures trading occurs in plain view of the Commission every day.

Ironically, revoking the hedge exemption might discourage swap dealers from offsetting their net risk through regulated futures trading activities and might actually make the Commission's two stated concerns more likely to occur. In that sense, maintaining the dealer hedge exemption promotes regulated trading and enhances transparency to facilitate the Commission's market surveillance, the very objectives the Commission cites as the basis for considering whether to revoke the exemptions.

Any case to revoke the dealer hedge exemption must be grounded in a concern with some reasonable factual basis that the dealers' futures market hedges are contributing to either price manipulation or what the statute defines as "excessive speculation" -- "sudden or unreasonable fluctuations or unwarranted changes" in futures market prices. Neither the Commission's Staff Report nor the concept release even attempts to make the case that the dealers' futures trading raises either concern. Given the transparent record of the swap dealers' trading activities over many years since the exemption was first granted, the absence of any claim or evidence supporting this position is most telling.

Revoking the Hedge Exemption Would Increase Speculation and Risk.

FIA expects other commentators to represent the views of the swap dealers and to describe the impact repeal of the hedge exemption may have on the dealers. FIA's opposition to repeal of the dealer hedge exemption is grounded in broader considerations. Based on the

available evidence, swap dealers use futures markets in an economically appropriate manner to reduce the price risks the dealers inevitably face in running their operations. The CFTC Staff Report contains no evidence that a swap dealer used the hedge exemption to manipulate a market price or caused even an "unwarranted change" in a futures market price. The report instead shows that dealers assume price risks their counterparties are trying to avoid. Dealers then offset their net price risk on the futures market.

To obtain an exemption, a swap dealer must prove to the Commission and DCMs, as applicable, that the dealer's trading in futures would offset its actual net price risk in an economically appropriate manner. Like other hedge exemptions, the dealer hedge exemption itself is not open-ended. In granting hedge exemptions, the Commission and the DCMs limit the amount of futures trading activity the dealer may engage in under the exemption. The Commission and DCMs also may impose additional regulatory conditions on those obtaining the exemption, as they would for other hedgers.

Given these facts, it is hard to imagine how the dealer could be said to be speculating in futures markets when the dealer establishes and resets futures positions to offset the net price risks the dealer assumes on swap transactions with its counterparties. For that reason, repealing the dealer hedge exemption could rob the Commission's bona fide hedge definition of its well-established meaning. Corporations, pension funds, mutual funds and hedge funds that regularly use futures to offset price risks from other forms of financial transactions could lose their hedge status and be forced to use futures to offset price risks only within the prescribed speculation limits. These are major participants in the futures markets. For decades, the Commission and other policy makers have sought to encourage their use of the open, transparent, liquid and financially-secure trading facilities offered by regulated futures exchanges. The CFTC Staff Report details these actions and the longstanding congressional interest in facilitating regulated risk management techniques.

No convincing case has been made, or could be made, to reduce the important liquidity each of these major market participants, including dealers, now contributes to the futures markets or to remove the price risk protection each of these entities now enjoys through regulated markets in currencies, interest rates, equity indexes, energy and agricultural commodities. But these adverse consequences are likely if the dealer hedge exemption is repealed. Less hedging means more price risk exposure for businesses and more risk for our economy as a whole. Especially in these challenging economic times, more risk exposure should be discouraged, not encouraged, by regulatory policy. The simple truth is irrefutable: when dealers establish futures positions to offset price risks they assume in swap transactions, they are hedging and the Commission/DCM exemptions that recognize that economic fact should not be repealed.

Revoking the Hedge Exemption Could Distort Market Surveillance.

Some have argued for treating all of a swap dealer's futures positions as speculation by revoking the hedge exemption. That policy would surely distort market surveillance in many circumstances. The CFTC staff report confirms this risk. Swap dealers futures positions are not mirror images -- on a gross basis -- of their counterparties swaps positions. Instead, "[F]utures market trades by swap dealers are essentially an amalgam of hedging and speculation by their clients. Thus, any particular trade that a swap dealer brings to the futures market may reflect information and decisions that originated with a hedger, a speculator, or some combination of both." CFTC Staff Report at 1-2.

Revoking the dealers' hedge exemption and treating their futures positions as speculative would distort market behavior. It is possible that all of a dealer's swap counterparties are hedgers (some long and some short) and that the "amalgam" of internal swap activity on a dealer's book would reflect just hedging activity. But when the dealer trades in futures to offset its net price risk, with the hedge exemption unavailable, it would be considered to be a speculator. That distorts economic reality in two ways. First, the dealer is hedging its net price risk, not speculating. Second, even if that hedging is disqualified, the dealer's futures position is caused by pure hedging activity of the dealer's swap counterparties. Characterizing that futures trading as speculation is surely a distortion.

Another problem illustrated by the CFTC Staff Report is traceability and practicality. As the Commission's staff report confirms, swap dealers enter into many different swap transactions to net their exposures with multiple counterparties, including those assuming risk, hedging risk and dealing in risk. If the character of the swap transactions drives the characterization of the dealer's offsetting futures position, it will be very difficult, if not impossible, for the dealer and its futures commission merchant to sort out the proper characterization of the dealer's futures position. Given that kind of characterization uncertainty, the Large Trader Reports to the Commission on the dealer futures positions are likely to vary widely in terms of how to label the underlying trading activity, what the Staff Report calls the "amalgam" of its speculating and hedging swap counterparties. That kind of variety will not lead to enhanced transparency. Commission market surveillance will surely suffer. The ability of market participants to draw accurate conclusions from weekly Commitments of Traders reports also will be further compromised.

A Different Regulatory Approach.

On June 4, 2009, Commission Chairman Gary Gensler testified on the need for a comprehensive framework to regulate the OTC derivatives market. Among other proposals,

Chairman Gensler recommended that OTC positions in contracts that "perform or affect a significant price discovery function with respect to regulated markets" should be aggregated for position limit purposes with the applicable position limits for corresponding regulated markets.[2] An implicit corollary of Chairman Gensler's proposal is that some form of reporting system would apply to those price discovery related OTC positions.[3]

FIA understands the CFTC's market surveillance interest in any OTC derivatives transactions that contribute to the price discovery process on CFTC-regulated markets. The Commission's existing special calls to swap dealers and index fund managers were borne out of that interest. The Commission may surely utilize that data to consider whether additional direct regulation would be appropriate for significant price discovery OTC transactions. At the least, FIA believes the Commission should consider initiating a rulemaking on these issues based on its analysis of the data it has collected through its special call authority and focusing on what impact, if any, OTC transactions have had on price discovery in regulated futures markets. The Commission may propose, as part of the rulemaking, to adopt a monthly reporting requirement for swap dealers that mirrors its current, ongoing special calls for OTC derivatives information. Perhaps such a rulemaking also could be combined with the Commission's announced rulemaking on how to treat non-cleared significant price discovery contracts on eligible commercial markets. See 74 Fed. Reg. 12181 (March 23, 2009).

In any event, FIA believes it would be problematic for the Commission by rule to impose on swap dealers certification requirements. Indeed, using the swap dealers to classify and certify the character of their counter-parties' OTC transactions may result in inaccurate data and distorted market surveillance, as the dealers lack the relevant information to double check any representation by its swaps counterparty as to whether its swap transactions are hedges or speculation. Nor should those counterparties be forced to divulge that commercially sensitive information to their opposite parties in the swap negotiations; otherwise buy-side swap market participants would be operating at a significant informational disadvantage with their dealers. The Commission's special calls directly to 14 commodity index fund managers may reflect its appreciation of that market reality. See CFTC Staff Report at 16.

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2 Statement of Gary Gensler, Chairman, CFTC, Before the Senate Committee on Agriculture, Nutrition and Forestry, June 4, 2009, page 5.

3 According to Chairman Gensler, even for "customized' OTC derivatives that would not be subject to exchange-trading or a clearing system, the Commission should have the authority to impose recordkeeping and reporting requirements as well as a full audit trail of these transactions. Statement of Gary Gensler, Chairman, CFTC, Before the Senate Committee on Agriculture, Nutrition and Forestry, June 4, 2009, page 7.

For these reasons, FIA believes the stated conditions in the recommended limited risk management exemption would be unwise and unworkable. That is why we have declined to address the specific questions raised in the concept release that focus on the framework contemplated by the recommendation.

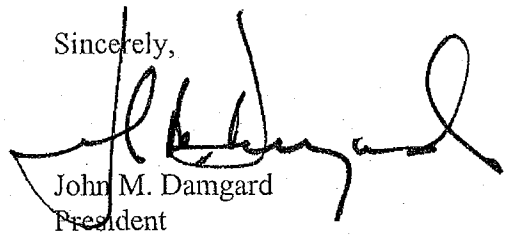
Conclusion.

The Commission's concept release addresses a very important regulatory issue -- how best to preserve and protect the integrity of the price discovery process. FIA believes these issues should be addressed now through a Commission rulemaking on how, if at all, different types of OTC derivatives affect price discovery in futures markets. Once these issues have been analyzed, based on data obtained from the Commission's special calls and any other sources, the Commission will be in a better position to determine what regulatory authorities should be applied to those OTC derivatives that serve a significant price discovery function. This approach is consistent with the amendments to the CEA Congress adopted in 2008, as well as recent statements by the Obama Administration and Chairman Gensler. FIA understands that the Commission may well determine that it needs additional statutory authority to extend its market surveillance powers in this area. If so, FIA would welcome the opportunity to work with the Commission in developing its proposals.

FIA would not support repealing the dealer hedge exemption or replacing it with a limited risk management exemption. In our view, repealing the hedge exemption would harm those who rely on U.S. futures markets by calling into question the sound economic analysis that has served as the foundation for the Commission's bona fide hedging definition for decades. In addition, the recommended risk management exemption would impose on dealers regulatory conditions they could not meet and that might actually compromise Commission market surveillance goals.

FIA believes the policy goals of CFTC Staff Report recommendation #5 could best be achieved by a different, more direct regulatory approach as outlined by Chairman Gensler, rather than the indirect certification approach the recommendation contemplated. FIA strongly supports making sure the Commission has all the necessary market surveillance data it needs to ensure the integrity of the futures market price discovery process. We look forward to working with the Commission to accomplish that goal.

Sincerely,



John M. Damgard
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