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

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Via Electronic Mail: secretary@cftc.gov

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

COMMENT

Re: 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

Dear Mr. Stawick:

Managed Funds Association ("MFA")[1] appreciates the opportunity to comment on the Commodity Futures Trading Commission's (the "Commission" or "CFTC") 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" (the "Concept Release").[2] MFA's members are active participants in the commodity markets, including the over-the-counter ("OTC") swap markets; provide important liquidity to both the long and short-side of the markets; and often assume the price risk that hedgers in the futures market and OTC swap market wish to off-set.

I. SUMMARY

The Concept Release raises issues related to the general regulation of OTC derivatives, which have since been raised in the context of a Congressional proposal, several Congressional hearings and the Obama Administration's regulatory reform plan.[3] As market participants,

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[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] 74 *FR* 12282 (Mar. 24, 2009) (the "Concept Release").

[3] *See* H.R. 2454, 111th Cong. (2009); *Regulatory Reform and the Derivatives Markets: Hearing Before the Senate Committee on Agriculture, Nutrition and Forestry,* 111th Cong. (June 4, 2009); *The Effective Regulation of the Over-the-Counter Derivatives Markets: Hearing Before the Subcomm. on Capital Markets of the House Comm. on Financial Services,* 111th Cong. (June 9, 2009); *and* Regulatory Reform Over-The-Counter Derivatives, U.S. Dept. of the Treasury (May 13, 2009) *available at: http://www.treasury.gov/press/releases/tg129.htm. See also Over-the-Counter Derivatives: Modernizing Oversight to Increase Transparency and Reduce Risks, Hearing scheduled to take place Before the*

MFA's members are actively involved in the reform dialogue and share a strong interest in greater transparency and accountability in the commodity markets. We believe it is important for the Commission to consider the *bona fide* hedge exemption for swap dealers within the broader OTC derivatives regulatory reform context rather than in isolation. We also believe that the Commission should seek more market data to understand the role and market impact of these *bona fide* hedge exemptions before it makes a determination on their elimination and/or replacement. The current data are insufficient to support a data driven rulemaking process and could result in premature action with unintended consequences. We believe greater transparency is needed in the commodity markets and recommend the Commission propose rulemaking to collect futures market and OTC swap market information on a regular basis. Such data will help inform the discussion on *bona fide* hedge exemption, shine further light on the activity of swap dealers and index traders, and assist the Commission in monitoring for market manipulation.

Finally, we believe the Commission should consider the alternative roles of speculators and index traders in the market when considering the OTC derivatives proposals and the bona fide hedge exemption issue. The importance of speculators is well established and essential to the smooth functioning of the commodity markets. In contrast to index funds, hedge funds and managed futures are long-time participants in the commodity markets who provide liquidity to both the long and short sides of the market and often assume the price risk hedgers wish to offset.

II. BACKGROUND

A. General Background

In the spring and summer of 2008, volatility and price increases in energy and agricultural commodities sparked widespread public and political concern. During this period, crude oil, wheat, corn, rice, soybeans and oats all reached record high prices.[4] Economic analyses indicate that supply and demand fundamentals caused the price changes.[5] Nevertheless, certain individuals and interest groups allege that excessive speculation by long-only traders caused the price changes and prompted Congress to introduce legislation that would limit speculation through CFTC-set position limits and by eliminating the ability of swap dealers to use the *bona fide* hedge exemption to hedge financial risk.[6]

Subcomm. on Securities, Insurance and Investment of the Senate Banking Comm., 111th Cong. (June 22, 2009).

[4] CFTC Staff Report on Commodity Swap Dealers & Index Traders with Commission Recommendations, September 2008 ("September 2008 Report") *at* p.10.

[5] *See* International Energy Agency World Energy Outlook, November 2007; Oil Sketches Monthly, Commodities Research, May 22, 2008, Barclays Capital; IMF World Economic Outlook, Chapters 1 and 3, International Monetary Fund (October 2008), *available at:* http://www.imf.org/external/pubs/ft/weo/2008/02/index.htm.

[6] *See, e.g.,* Testimony of Michael W. Masters before the U.S. Senate Committee on Homeland Security and Governmental Affairs on May 20, 2008; H.R. 6604, 110th Cong. (2008).

In June of 2008, the Commission initiated a special call to futures traders, including swap dealers engaged in commodity index business, other large swap dealers and commodity index funds, to collect more information on the off-exchange commodity trading activity of swap dealers.[7] The Commission provided an analysis of the special call information in the "Staff Report on Commodity Swap Dealers & Index Traders with Commission Recommendations" ("September 2008 Report"). As part of its recommendations, the Commission recommended the staff review whether to eliminate the *bona fide* hedge exemption for swap dealers and create a new limited risk management exemption. Accordingly, the Commission staff issued and seeks comment on the Concept Release.

B. The *Bona Fide* Hedge Exemption

Section 4a(c) of the Commodity Exchange Act ("CEA") provides that speculative position limits shall not apply to positions held for *bona fide* hedging purposes as defined by the CFTC. As noted in the Concept Release, the Commission has periodically amended the exemptive rules applicable to Federal speculative position limits in response to changing conditions and practices in the futures markets.[8] In 1986, both the House and Senate Agricultural Committees urged the Commission to consider including risk management in its hedging definition to ensure that the definition was "consistent with the legitimate needs and practices of the industry."[9] In 1987, upon the recommendation of the Commission's Financial Products Advisory Committee, the Commission issued interpretive guidance providing that "risk-management" be included as a type of speculative position limit exemption.[10]

In 1991 the Commission began granting *bona fide* hedge exemptions in agricultural futures markets to a number of swap dealers who were seeking to manage price risk on their books as a result of their serving as market makers to their OTC clients.[11] These clients included pension funds, index funds, managed funds and other institutional investors seeking exposure to commodities as an asset class. Swap dealers provided these clients commodities exposure through swap contracts that tracked published commodity indexes such as the S&P Goldman Sachs Commodity Index or the Dow Jones AIG Commodity Index.

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[7] September 2008 Report.

[8] Concept Release *at* 12283.

[9] S. Rep. 99-291, at 22 (1986) (urging the Commission to consider "whether the concept of prudent risk management [should] be incorporated in the general definition of hedging as an alternative to the risk reduction standard."); *see also* H.R. Rep. No. 99-624, at 44-46 (1986) (urging the Commission to "undertake a review of its hedging definition . . . and to consider giving certain concepts, uses, and strategies 'non-speculative' treatment.").

[10] *Risk Management Exemptions from Speculative Position Limits Approved under Commission Regulation 1.61,* 52 *FR* 34633 (Sept. 14, 1987); *Clarification of Certain Aspects of the Hedging Definition,* 52 *FR* 27195 (July 20, 1987).

[11] Concept Release *at* 12284.

In the last decade, swap trading has become especially popular with the advent and development of commodity index funds, exchange-traded funds for commodities ("ETFs") and exchange-traded notes ("ETNs")—all primarily transacted through swap trading. The influx of index traders has contributed to the volume growth in the futures markets, as well as to the growth of the OTC commodity derivatives markets.

II. DISCUSSION

The purpose of the Commission's special call, which remains ongoing, is to gather more information regarding the off-exchange commodity trading activity of swap dealers to better characterize their activity and understand their potential to influence the futures markets, such as the price and volatility of these markets. The Concept Release requests comment on whether to eliminate the *bona fide* hedge exemption for swap dealers and replace it with a limited risk management exemption that is conditioned upon, among other things: (1) an obligation to report to the CFTC and applicable self-regulatory organizations when certain noncommercial swap clients reach a certain position level; and/or (2) a certification that none of a swap dealer's noncommercial swap clients exceed specified position limits in related exchange-regulated commodities (the "Limited Risk Management Exemption").

A. Regulatory Reform of OTC Derivatives Markets

Since the Commission issued the Concept Release, there have been a number of legislative developments with respect to OTC derivatives regulation. On May 13, the Obama Administration issued a framework for OTC derivatives regulation, and on June 17, issued a financial regulatory reform white paper that includes OTC derivatives regulation.[12] On June 4, the Senate Agriculture Committee held a hearing on OTC derivatives; on June 9, the Capital Markets Subcommittee of the House Financial Services Committee held a hearing on OTC derivatives; and we understand that many more Congressional hearings will be scheduled on this issue as part of the larger debate on U.S. financial regulatory reform.

MFA supports the four key objectives of OTC derivatives regulation set forth by the Obama administration:

- Preventing activities in those markets from posing risk to the financial system;
- Promoting the efficiency and transparency of those markets;
- Preventing market manipulation, fraud and other market abuses; and
- Ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.[13]

Also, the U.S. Senate confirmed Chairman Gensler since the Commission issued the Concept Release, and he is providing leadership on a comprehensive regulatory framework on OTC derivative markets and has requested an in-depth review of the *bona fide* hedge exemption issue specifically.

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[12] Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation, Department of the Treasury, June 17, 2009 *available at:* *http://www.financialstability.gov/docs/regs/FinalReport_web.pdf*.

[13] Letter to the Honorable Harry Reid, Senator, from Timothy F. Geithner, Secretary, Department of the Treasury, on May 13, 2009 *available at:* http://www.financialstability.gov/docs/OTCletter.pdf.

We believe the Commission should consider the *bona fide* hedge exemption for swap dealers in the context of the broader goals of OTC derivatives regulatory reform. Regulation of swap derivatives and swap dealers should be consistent with regulation of other OTC derivative products and dealers. As the Commission considers rulemaking in this area, we urge the Commission to coordinate its activities with other financial regulators.

B. The *Bona Fide* Hedge Exemption

MFA commends the Commission staff for its work and analysis in reviewing a large volume of OTC market information in a relatively short period to produce the September 2008 Report. MFA finds the quantitative data provided in the September 2008 Report highly informative to the regulatory and rulemaking process. In fact, MFA submits that rulemaking should generally be predicated on empirical evidence to minimize market disruptions.

The CFTC produced the September 2008 Report in response to allegations that index traders and other speculators were the cause of the volatility and high price of oil and other commodities during 2008. On one hand, the Commission found that recent price movements are attributable to market fundamentals and not to trading by speculators. On the other hand, the Commission found that its preliminary survey could not accurately determine and quantify the amount of speculative trading occurring in the futures markets.

1. Speculation: Managed Futures vs. Index Funds

First, MFA would like to distinguish the role in the commodity markets between its members and index traders. Hedge funds and managed futures traders are active and long-time participants in the commodity markets. Unlike index funds, our members provide important liquidity to both the long and short-sides of the markets, often assume the price risk that commercial hedgers in the futures market and OTC swap market wish to off-set. Hedge funds and managed futures, as speculators, **are not** eligible for a Commission-granted *bona fide* hedge exemption from position limits.[14] In contrast, index funds are relatively new participants to the commodity markets, are passively-managed, long-only investors that **are granted** the *bona fide* hedge exemption from the Commission. As the Commission examines more data on market activity and reviews the *bona fide* hedge exemptions for swap dealers, we believe it is important to consider the respective roles of different market participants.

2. The *Bona Fide* Hedge Exemption and Index Funds

As market participants, MFA members share the Commission's concern about the impact of the influx of long-only positions for orderly markets. We believe, however, that the Commission should further examine the impact of ETFs, ETNs and index funds on the futures markets before issuing rulemaking aimed at changing market composition. The data to date are insufficient to ensure an empirically driven rulemaking process. We believe rulemaking should be predicated on empirical data to prevent negative unintended consequences and disruption to the markets. In addition, the Commission should examine the structure of the indices and

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[14] However, hedge funds and managed futures are eligible for exchange-granted exemptions from time to time and on a case by case basis.

underlying contracts to determine whether market issues, such as the lack of cash-futures convergence could be caused by the structure of contracts rather than exemptions to position limits.

C. Greater Transparency in the Swap Markets

MFA believes that greater information on commodities that are related to commodity futures is needed in order to reduce market uncertainty, to better understand the fundamentals driving the market, to bring greater transparency to the OTC swap markets and to better monitor for manipulation in commodity futures markets. To achieve this objective, the Commission should propose rulemaking to regularly collect information from swap dealers and commodity index funds relating to their total activity in the futures and OTC swap markets, and to categorize the activities of their customers, similar to the information the Commission currently collects through its special call.

We believe greater transparency, information and understanding of the OTC swap markets will more directly address the concerns behind the Commission's Concept Release and the objectives of the contemplated Limited Risk Management Exemption. With such a rule, the Commission should explore the types and format of additional information that could be collected from swap dealers on a regular basis to help the Commission better understand the relationship between the OTC swap markets and the futures markets.

In addition, we believe the Commission should provide the public with greater transparency with respect to OTC swap markets relating to commodity futures markets through aggregated reports. Aggregate reports would protect the confidentiality of the individual positions and trade secrets of customers, in compliance with section 8 of the CEA. We believe the public would benefit from information, such as the size of various OTC swap markets, the value of swap positions that are internally netted by swap dealers, and the number of futures market trades effected by swap dealers to offset risk. Such information would also help inform the regulatory and rulemaking process, should the Commission determine that rulemaking relating to the *bona fide* hedge exemption becomes necessary.

Accordingly, MFA recommends that the Commission propose rulemaking to collect information from swap dealers and commodity index funds on a permanent, ongoing basis.

III. CONCLUSION

In light of the recent legislative and policy making activity concerning the regulation of the OTC derivatives markets, we believe it is important for the Commission to consider the *bona fide* hedge exemption in the context of the broader OTC derivatives regulatory reform goals and objectives. MFA members are active participants in the commodity markets, and as such, have a strong interest in the integrity, transparency and efficiency of these markets. MFA urges the Commission to carefully examine the causes behind recent market distortions. Finally, MFA supports greater transparency with respect to OTC swap market activity and recommends that the Commission propose rulemaking to require swap dealers and index traders to report OTC swap market transactions to the Commission on a permanent, ongoing basis.

We would be happy to discuss our comments 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,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President & General Counsel

CC: The Hon. Gary Gensler, Chairman
The Hon. Michael Dunn, Commissioner
The Hon. Walter Lukken, Commissioner
The Hon. Jill E. Sommers, Commissioner
The Hon. Bart Chilton, Commissioner