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COMMENT

June 18, 2009

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

RE: Response to CFTC Request for Public Comments: "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:

UBS AG and UBS Securities LLC (collectively "UBS") appreciate the opportunity to submit its comments on the above-referenced Concept Release. UBS AG is a provider of commodity index trading vehicles to its clients, specifically, the UBS Bloomberg Constant Maturity Commodity Index (CMCI) and the recently acquired Dow Jones-UBS (formerly American International Group ("AIG")) Commodity Index (DJ-UBS CI (previously DJ-AIG CI)). The DJ-UBS CI and the CMCI are broad-based commodity indices comprised of 19 futures contracts and 26 futures contracts respectively, and the respective exchanges where they are traded include all of the major U.S. exchanges as well as some non-US exchanges. The DJ-UBS is a widely used commodity index and an internationally referenced economic benchmark with rules regarding diversification by sector and individual commodity. The CMCI was launched in early 2007 and further diversifies contract exposure by time from three months to as long as three years depending on the specific commodity. These indices are highly transparent with intra-day and daily closing levels of the index available on reporting channels such as Reuters and Bloomberg. Information on the daily closing and settlement prices of the futures contracts that make up the index is available on the websites of the respective futures exchanges, and other sources of real time data on the contracts is available by subscription from several real-time quotation vendors, including Reuters and Bloomberg. Any adjustments to the indices are published on the Dow Jones and UBS websites.

The demand for pension plan diversification is large, defined and growing. Private sector pension plan investments are governed by ERISA. Although public sector pension plans are governed by state law, many states have adopted standards similar to ERISA. Under ERISA regulations, a pension plan fiduciary must observe a "prudent man" standard of care and, among other things, must diversify plan investments to minimize the risk of large losses. It has become acceptable under this diversification requirement for pension plan managers to invest in commodity index vehicles. Therefore, there is a sizable and growing need for diversified risk management vehicles for pension plans.

Similarly, this current economic crisis has also given rise to increased demand for diversification of investments for endowments and foundations.

The Commission's Recognition of Hedging (Or Risk Management of) Financial Risks

As the hedging of financial risks has increased over the past 20 years, we believe that the CFTC's recognition of the legitimate nature of such hedging has been appropriate.[1] Swaps market participants as well as swap dealers holding positions on behalf of their swaps customers have been eligible for exemptions from speculative position limits when hedging the associated financial risks.

The Definition of "Hedging" with Respect to Financial Risk Mitigation

In order to determine whether an applicant for an exemption is justified, the Commission has had to make a determination about the definition of "hedging" in many different contexts.[2]

In its 1987 Federal Register release on hedging[3], the CFTC recognized financial exposures as risks that could legitimately be mitigated by utilizing futures markets and deserving of an exemption from speculative limits. (We suggest terming this "financial hedging" (or warranting a "risk management exemption") as opposed to "commercial hedging."[4]

Consistent with the CFTC's treatment of the mitigation of risks arising from commercial activities, the CFTC allows exemptions from speculative position limits for the mitigation of

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[1] We suggest that the Commission consider changing its terminology with respect to the terms "bona fide hedging" and "risk management." The definition of "bona fide" is "1. characterized by good faith and lack of fraud or deceit; 2. valid under or in accordance with the law; 3. made with or characterized by sincerity; or 4. being real or genuine. (*"bona fide."* In *Webster's Revised Unabridged Dictionary.* Source location: MICRA, Inc. http://dictionary.reference.com/browse/bona fide>.) Since the activity of mitigating risk with respect to physical market exposures is also actually 'risk management' and the financial exposures mitigated by hedging financial exposures are real, 'bona fide' risks, we suggest using the terms "commercial hedging and "financial hedging."

[2] Pursuant to Section 4a(a) of the Commodity Exchange Act ("CEA"), the Commission is charged with establishing and enforcing speculative position limits for futures and options contracts on some agricultural commodities. Those limits are listed at § 150.2 of the Commission's regulations. Section 150.3(a) of those regulations provides that certain positions may exceed the limits, including *bona fide* hedging transactions, as defined in Regulation 1.3(z). Section 1.3(z)(3) provides that, in addition to certain enumerated hedging transactions listed in § 1.3(z)(2), the Commission may recognize other transactions and positions as *bona fide* hedging in accordance with requirements set out in § 1.47 of the regulations.

[3] The Commission's 1987 interpretation clarified the hedging definition "to include certain investment strategies of institutional investors, such as through acquiring a long position in Treasury bond futures to hedge against interest rate exposure." 52 FR 27195 (July 20, 1987).

[4] Commercial hedging could be defined as the mitigation of risks arising from a market participant's management of a commercial enterprise, arising from: 1) The potential change in the value of assets which a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing or merchandising; 2) The potential change in the value of liabilities which a person owns or anticipates incurring; or 3) The potential change in the value of services which a person provides, purchases or anticipates providing or purchasing.

financial risks (or "risk management exemptions"). These investors are not speculators – they have net long positions in financial markets and are using those positions to hedge inflation and financial risk that exists elsewhere in their portfolios. Like traditional commercial hedgers, these futures market participants are using futures for risk mitigation.

Commodity Index Futures Trading

Another way in which financial risk is mitigated is through long positions in a wide range of commodity futures. These types of instruments are used to diversify portfolios and hedge against inflation. There are several ways in which these participants mitigate their risks. They may choose to create a basket of commodity exposures, which they trade as individual futures positions, with concomitant rollover issues. However, pension funds, endowments and other institutional investors, as well as individuals are much more likely to trade commodity index swaps directly with a swaps dealer or through commingled vehicles such as commodity index mutual funds.

As shown in many empirical studies (discussed later in this letter), these index investors, either directly or through a swaps dealer, have been proven to promote market stability by increasing liquidity, thus enabling more efficient hedging by commercial hedgers. These index traders, as well as their intermediaries, should be granted exemptions from speculative position limits.

In 2006, recognizing that commodity index trading could provide an effective hedge against inflation and other portfolio risks, the CFTC's Division of Market Oversight issued two interpretive letters in response to hedge exemption requests relating to index trading. The Commission granted no-action relief from the speculative position limit provisions of § 150.3 of the regulations based on the Commission's finding that these passive index trading activities (similar to those of an index provider) constituted hedging transactions in that they were "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise."[5] In that case, like an index provider, the petitioner's only objective was to track the index over time (through acquiring long futures positions), using a nondiscretionary methodology, with no investment objective to "achieve capital appreciation.". These investors are not seeking to take a view on one specific market. Therefore, the Commission agreed that the petitioner should be viewed as "akin to a commercial enterprise that is in the business of investing and reinvesting in long futures positions in the index commodities with no intent to speculate in the futures market and which poses no "danger of excessive speculation." '[6]

In these two letters, CFTC staff stated that the use of the futures markets by funds to provide their investors with a commodity-index exposure represented a legitimate and potentially useful investment strategy.

Based on the Commission's determination that this index trading was indeed bona fide hedging as defined in Reg. 1.3(z), no-action relief was granted under the following conditions:

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[5] This determination is consistent with the Commission's 1987 interpretation clarifying the hedging definition "to include certain investment strategies of institutional investors, such as through acquiring a long position in Treasury bond futures to hedge against interest rate exposure." 52 FR 27195 (July 20, 1987).

[6] CFTC Interpretive letter 2006-09?

1. The futures trading activity passively tracks a widely recognized commodity index.
2. The futures trading activity is unleveraged.
3. The futures trading profits/losses are passed along to investors.
4. Positions in excess of the speculative limits are not carried into the spot month.

In today's futures markets, commodity index trading, which is commonly subject to the above conditions, has been studied extensively to determine whether there is an adverse impact on commodity futures market prices. More recently, given the run-up in prices of a broad range of physical commodities since mid-2008, the impact of index trading has also become the subject of public debate.

One of the issues that has arisen in conjunction with these studies is the relative paucity of publicly available data on trading done for the purpose of 'financial hedging' or pursuant to "risk management exemptions." We support the Commission's efforts to differentiate between these risk management activities and speculation by creating a new category of trading for inclusion in its Commitments of Traders ("COT") reports. We also encourage the Commission to continue to use its Special Call capabilities to review the underlying data and further examine its impact.

In late 2008, the GAO was commissioned to, among other things, review these empirical studies. As reported by the GAO in its December 2008 Briefing to the House Committee on Agriculture,[7]

> "Although not included in the enclosed briefing slides, we also are providing information on the results of our review of studies analyzing the impact that index traders and other futures speculators have had on commodity prices. Through our literature search, we identified eight empirical studies and three qualitative studies. ..Unlike the empirical studies, the qualitative studies do not use experimental or statistical controls to evaluate the causal relationship between speculative trading and commodity prices and, thus, do not provide a systematic way to assess the empirical veracity of the causal relationship. Importantly, the eight empirical studies we reviewed generally found limited statistical evidence of a causal relationship between speculation in the futures markets and changes in commodity prices – regardless of whether the studies focused on index traders, specifically, or speculators, generally. Four of the studies used CFTC's publicly available Commitments of Traders (COT) data in their analysis, and their findings should not be viewed as definitive because of limitations in that data. For example, the public COT data are issued weekly, and analyses using such data could miss the effect of daily or intraday changes in futures positions on prices. Also, these data generally aggregate positions held by different groups of traders and, thus, do not allow the effect of individual trader group positions on prices to be assessed. Two of the studies we reviewed involved CFTC staff and used non-public COT data that included positions reported more frequently and separated positions held by different trader groups. However, similar to the studies that used the public COT data, the studies using the non-public data also found limited evidence that speculation was affecting commodity prices. In addition, all of

[7] GAO Report Number GAO-09-285R, "Issues Involving the Use of the Futures Markets to Invest in Commodity Indexes," released February 5, 2009.

the empirical studies we reviewed generally employed statistical techniques that were designed to detect a very weak or even spurious causal relationship between futures speculators and commodity prices. As [a] result, the fact that the studies generally did not find statistical evidence of such a relationship appears to suggest that such trading is not significantly affecting commodity prices at the weekly or daily frequency."[8]

Again, while these studies could be more conclusive had the requisite data been more granular, the conclusion of one of the more detailed studies cited by GAO[9] is illustrative of the general trend of all cited studies:

"While the analysis in this report does not test [for] directly for price impacts, it does provide some pertinent evidence in this regard. First, if there is a market impact from index fund activity, it seems likely that it would have occurred during the period of most rapid growth: 2004-2005. Second, the stabilization of the index funds' percent of total open interest may suggest that other traders have adjusted their strategies to better cope with this relatively new market participant. Third, Working's speculative index suggests that long-only index funds may in fact be beneficial in markets dominated by short hedging pressure. That is, they improve the adequacy of speculation by helping the market to "carry" unbalanced short hedging. However, the traditional notion that hedging begets speculating may need to be revisited. The relatively normal level of speculation over the sample period raises some doubt as to whether index funds are behind recent commodity price increases."

"Much like in the last major episode of structural change in commodity markets in 1972-1975, some are blaming speculators for the recent increase in commodity prices. Proposals are once again surfacing to increase margins in an effort to curb 'harmful' speculation in futures markets. Such policy decisions aimed at curbing speculation may well be counter-productive in terms of price levels or market volatility. In particular, these policy initiatives could severely compromise the ability of futures markets to accommodate hedgers and facilitate the transfer of risk."

Another way of examining the impact of commodity index trading on futures market pricing is to compare the futures markets which are included in indexes with those that are not:

"There are additional reasons to be skeptical about the assertion that speculation has led to bubbles in agricultural futures prices over the last two years. First, the research presented in this report shows that the level of speculation in agricultural futures markets....is not outside of historical norms. If speculation is driving prices above fundamental values, it is not obvious in the level of speculation relative to hedging. Second, recent price

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8 Id, pp. 5-6.

9 Sanders, D.R., S.H. Irwin, and R.P. Merrin. "The Adequacy of Speculation in Agricultural Futures Markets: Too Much of a Good Thing?" Marketing and Outlook Research Reprot 2008-02, Department of Agricultural and Consumer Economics, University of Illinois at Urbana-Champaign, June 2008, at pp. 17-18. [http://www.farmdoc.uiuc.edu/marketing/morr/morr_archive.html]

increases do not neatly fit a bubble explanation. As shown in Figure 14, price increases are concentrated in the grain and oilseed markets. Yet, the highest concentration of long-only speculative positions is often in the livestock futures markets (Table 3), which generally did not participate in the price increases and for which index funds are rarely mentioned as problematic. It is difficult to rationalize why speculation by index funds would only impact particular agricultural futures markets. Third, very high prices have been observed for commodities without futures markets (e.g., durum wheat and edible beans) and in agricultural futures markets that are not included in popular commodity indices (e.g., rice and fluid milk). To assert that the commodity markets are being driven higher by a speculative bubble ignores historically low world grain inventories and other market fundamentals that are broadly driving commodity prices higher. Fourth....if speculators create a bubble in futures prices for storable commodities, this also creates an incentive to store commodities because prices in the future exceed levels normally required to compensate inventory holders for storage. We should therefore observe an increase in inventories when a bubble is present. In fact, inventories for grains and oilseeds have fallen sharply over the last two years."[10]

The conclusion that futures contracts which are not included in a traded commodity index experience the same or increased upward price movement, while some futures contracts that are included in indexes may have declining prices certainly detracts from claims that commodity index trading leads to increased futures prices.

Swaps Dealers' Exemptions

When index investors, such as pension plans, endowments or individuals, choose to mitigate their risks through the use of over-the-counter swaps based on commodity indices, their intermediary index swaps dealers absorb their risks and should be granted similar relief from speculative position limits. These swap dealers are engaged in the commercial enterprise of providing OTC commodity index exposure to their clients and, their resultant risks are very similar to those of a 'commercial' hedger. Swap dealers should be allowed to mitigate their risks with exemptions based the same conditions, above, (i.e., passive, unleveraged trading that does not take place in the delivery month) as applied to index traders themselves.

Index swaps dealers should be able to rely on the representations of their clients for purposes of regulatory reporting.

Pension Plan Commodity Index Exemptions

The demand for pension plan diversification is large, defined and growing. Private sector pension plan investments are governed by ERISA. Although public sector pension plans are governed by state law, many states have adopted standards similar to ERISA. Under ERISA

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[10] Id, at 15. (For purposes of this study, commodity index trading is included in the "speculative" category.) Charts and tables available at: [http://www.farmdoc.uiuc.edu/marketing/morr/morr_archive.html]

regulations, a pension plan fiduciary must observe a "prudent man" standard of care[11] and, among other things, must diversify plan investments to minimize the risk of large losses.[12] It has become acceptable under this diversification requirement for pension plan managers to invest in commodity index vehicles. Therefore, there is a sizable and growing need for diversified risk management vehicles for pension plans.

This current economic crisis has also given rise to increased demand for diversification of investments for the public at large, including pension funds of corporations, state and local government retirement plans that cover retired public service employees, endowments, charitable foundations and retail investors, among others.

Therefore, given recent market events and public discussions, this is an appropriate time for the Commission to re-examine the underlying issues with respect to the proposed new risk management exemption. In particular, we suggest that the Commission include an examination of the economic value of promoting price discovery and risk management needs of disparate market participants whose trading and transactions flow through the over-the-counter and exchange-traded markets to provide necessary market liquidity, balance and efficiency. Additionally, the Commission should examine reporting requirements to make trading associated with this new risk management category as transparent as other categories.

Furthermore, in the absence of evidence of adverse impacts of this type of trading and pending the outcome of further analysis, the CFTC should continue to issue exemptions from speculative position limits for market participants wishing to utilize futures markets to mitigate risks from financial exposures. Futures positions already held for the purpose of hedging swaps and commodity index exposures should be grandfathered into any new requirements so as to cause as little market disruption as necessary.

The amount of risk management trading allowed to swap dealers (and, therefore, the size of their hedge exemption) should be commensurate with the demand for index swaps by their clients. Commodity index swaps customers should be free to select the most desirable commodity index swap counterparty based on the creditworthiness of the swaps dealer, its pricing and trade efficiency. Since the ability of a commodity index swaps dealer to service its customers is directly related to the size of its futures hedge exemption, there should not be an overall limit on a swap dealer's futures and option positions in any one market regardless of the commercial or noncommercial nature of their clients.

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[11] ERISA Section 404(a)(1)(B) provides that a fiduciary must act "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

[12] 29 C.F.R. § 2550.404a-1(b)(1) (a fiduciary must give "appropriate consideration" to the facts and circumstances that the fiduciary knows or should know are relevant to the particular investments, including the role that the investment plays in the plan's investment portfolio;

29 C.F.R. §2550.404a-1(b)(2) (with respect to investment decisions, the concept of "appropriate consideration" includes a determination by the fiduciary that a particular investment or investment course of action is reasonably designed to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain associated with such investment; consideration should also be given to **(1) the diversification of the investment portfolio**; (2) the liquidity of the investment in relation to the liquidity needs of the plan, and (3) the projected investment return in relation to the funding objectives of the plan). (Emphasis added.)

A failure to grant this risk management exemption to or to limit positions of commodity index dealers would most probably not limit this index trading in futures markets. UBS agrees with the assessment that the result would be a greater number of smaller swaps dealers, rather than a dimunition of commodity index trading itself, since commodity index trading is an accepted method of diversifying portfolio risk for pension funds, endowments and other types of institutional investments. Granting risk management hedge exemptions to index swaps dealers benefits pension plans in that their managers will have a wider, more creditworthy and more efficiently priced range of index swap dealers from which to choose.

UBS appreciates this opportunity to comment on the Concept Release and commends the Commission for taking a leadership role in comprehensively examining issues related to financial hedging. We believe the CFTC's evolving record with respect to its treatment of commodity index trading has been thoughtful, detailed, comprehensive and fact-based. We urge the Commission to continue this process by structuring reporting requirements so that it has the requisite data to determine the most efficient way to regulate commodity index trading. If CFTC Commissioners or staff have any questions about our comments, please contact me or Mary Irwin, our Senior Futures Counsel, at (312) 525-6643.

Very truly yours,

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