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American Cotton Shippers Association

09-4
(2)



April 21, 2009 **COMMENT**



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

Re: 17 CFR Part 150
Concept Release
Whether to Eliminate Bona Fide
Hedge Exemption for Swap Dealers &
Create New Limited Risk Management
Exemption from Speculative Position Limits

Dear Mr. Stawick:

Pursuant to the Federal Register Notice (74 FR 12282) of March 24, 2009, the American Cotton Shippers Association submits the following comments on the issues posed by the Commission.

*A. General Advisability of Eliminating the Existing Bona Fide Hedge Exemption for Swap Dealers in Favor of a Limited Risk Management Exemption.*

1. Should swap dealers no longer be allowed to quality for exemption under the existing bona fide hedge definition?

   Swap dealers should no longer be allowed to qualify for exemptions under the existing bona fide hedge exemption. Only bona fide commercial entities actually producing, processing, merchandising, manufacturing, or consuming the physical commodity should be able to qualify for a hedge exemption.

2. If so, should the Commission create a limited risk-management exemption for swap dealers based upon the nature of their clients (e.g., being allowed an exemption to the extent a client is a traditional commercial hedger)?

   Yes, provided that both the swaps dealer and the commercial hedger, on whose behalf it is trading, be required to file a weekly report of all transactions entered into for or on its behalf and that such trades be reconciled and aggregated by the Commission from all risk management exemption entities to prevent the speculative limit from being exceeded.

3. If the bona fide hedge exemption were eliminated for swap dealers, and replaced with a new, limited risk management exemption, how should the new rules be applied to existing futures positions that no longer qualify for the new risk-management exemption?

   For example, should existing futures positions in excess of current Federal speculative position limits be grandfathered until the futures and option contract in which they are placed expire?

   No. A time horizon should be given after which all positions would need to be in full compliance with the new regulations. Otherwise, positions could be moved to much later expirations to avoid compliance. All positions should be afforded the same consideration by the Commission. A trading entity with a position in a nearby month should not be treated differently than trading entities with distant month positions – each should be subject to the same liquidation schedule.

   Should swap dealers holding such positions be given a time limit within which to bring their futures position into compliance with Federal speculative limits?

   Yes, see above.

   Should swap dealers holding such positions be required to bring their futures positions into compliance with the Federal limits as of the effective date of the new rules?

   Yes.

*B. Scope of a Potential New Limited Risk Management Exemption for Swap Dealers.*

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 reinterpretation 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?

   Yes. The bona fide hedge exemption should be extended to all commodities produced, processed, merchandised, manufactured, and consumed by any interest that uses the contract markets for hedging purposes in their commercial business.

C. *Terms of a Potential New Limited Risk Management Exemption for Swap Dealers.*

5. If a new limited risk management exemption were to be permitted to the extent a swap dealer is taking on risk on behalf of commercial clients, how should the rules define what constitutes a commercial client?

   A commercial interest is an individual or entity that produces, processes, merchandises, manufacturers, or consumes the commodity traded on a contract market.

6. How should the Commission (and if applicable, the responsible industry self-regulatory organization (SRO) and the swap dealer itself verify that a dealer's clients are commercial?

   All such individuals or entities holding themselves out to be a commercial should be required to register with the Commission and report their commercial activities. Such reports should be subject to verification audits by Commission on no less than a yearly basis.

   The swap dealer should be required to file similar reports for each of its commercial clients and the Commission should be required to reconcile and aggregate the positions of the commercial client and the swap dealer.

7. Is certification by the dealer sufficient or would something more be required from either the dealer or the client?

   Certification would be insufficient. The reporting procedure described above in response number 6 should be the minimum requirement.

   If so, what should be reported and how often – weekly, monthly, etc.?

   As stated above, mere certification is insufficient and would lead to abuses. The Commission must require regular reports of the swap dealer and his or her commercial client, monitor such reports closely, and reconcile and aggregate them to prevent trading in excess of the speculative limits.

8. For a swap dealer's noncommercial clients, should the rules distinguish between different classes of non-commercials – for example: (1) Clients who are speculators (e.g., a hedge fund); (2) Clients who are index funds trading passively on behalf of many participants; and (3) Clients who are intermediaries (e.g., another swap dealer trading on behalf of undisclosed clients, some of whom may be commercials)?

No. All noncommercial clients of a swap dealer should be treated similarly since each of them are speculators, each should be held to the same standards of reporting compliance, and each should be monitored closely to prevent trading in excess of the speculative limits. Particular attention should be given when a swap dealer is acting on behalf of another swap dealer allegedly trading on behalf of an alleged undisclosed commercial since this stratagem has been extensively used in recent years by swaps dealers to exceed the speculative limits.

9. If a swap dealer were allowed an exemption for risk taken on against index-fund clients, how would the dealer satisfy the Commission that the fund is made up of many participants and is passively managed?

   The Commission should require the index funds to report the amount of each individual or entity's investment so as to be certain that no single investor has exceeded his speculative position limits through a large index fund investment.

10. Is certification by the dealer or fund sufficient or should the dealer or fund be required to identify the fund's largest clients?

    No. Certification is not sufficient. All funds or dealers should register with the Commission and all of the funds clients should be identified to the Commission in order to assure that no commercial or non-commercial interest is using a fund to exceed the limits.

11. If a swap dealer were allowed an exemption for risk taken on against another intermediary, how would the dealer satisfy the Commission that its intermediary client does not in turn have noncommercial clients that are in excess of position limits?

    As stated above in response number 8, no such exemptions should be permitted since this was the primary stratagem utilized by swaps dealers to exceed the speculative limits.

    Is certification by the dealer or second intermediary sufficient or should the dealer or intermediary be required to separately identify the intermediary's largest clients?

    Certification should never be sufficient, especially if the Commission ignores the realities of this questionable practice. Under such circumstances, all of the intermediary's clients should be identified to the Commission, as explained in comment number 10, in order to assure that no commercial or non-commercial interest is attempting to exceed the limits.

12. What futures equivalent position level should trigger the new limited risk management exemption reporting requirement?

    For example, under the rules of the on-going special call to swap dealers and index funds described earlier, a swap dealer must report any client in any individual month that exceeds 25% of the spot month limit, or the net long or short position of a client that in all months combined exceeds 25% of the all-months-combined limit.

    The reporting requirement should be established at the same level currently required for each contract traded on a regulated commodity exchange.

13. If none of a swap dealer's clients exceed required reporting levels in a given commodity, or none of such clients exceed reporting levels in any commodity, what type of report should be filed with the Commission – e.g., a certification by the swap dealer to the Commission to that effect?

    The swap dealer should report his aggregate activity regularly regardless of whether or not his client exceeds the speculative limit.

14. Should there 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?

    For example, "A swap dealer may not hold an individual month or all-months-combined position in an agricultural commodity named in Sec.150.2 in excess of 10% of the average combined futures and delta-adjusted option month-end open interest for the most recent calendar year."

    Yes, a sensible standard or criteria should be applied to the aggregate positions of the swap dealer and his or her commercial and non-commercial clients so as to prevent any distortion and/or control of the market which could destroy its economic purpose of price discovery, convergence, and hedging.

15. If a new limited risk-management exemption for swap dealers is created, what additional elements, other than those listed here, should be considered by the Commission in developing such an exemption?

    Such an exemption should require weekly reporting, disclosure of counter parties, and aggregation of positions.

*D. Other Questions*

16. How should the two index traders who have received no-action relief from Federal speculative position limits be treated under any new regulatory scheme as discussed herein?[1]

    The no-action relief should be rescinded.

17. What information should be required in a swap dealer's application for a limited risk management exemption?

    The minimum information required should include its reporting capabilities and compliance procedures.

Thank you for the consideration of these comments and recommendations.

Respectfully submitted,

Joseph T. Nicosia,
President

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[1] The two index traders offered investors the opportunity to participate in a broadly diversified commodity index-based fund or program ("index fund"). The futures positions of these index funds differed from the futures positions taken by the swap dealers who had earlier received hedge exemptions. The swap dealer positions were taken to offset OTC swaps exposure that was directly linked to the price of an index. For that reason, Commission staff granted hedge exemptions to these swap dealer positions. On the other hand, in the index fund positions described in the no-action letters, the price exposure results from a promise or obligation to track an index, rather than from holding an OTC swap position whose value is directly linked to the price of the index. Commission staff believed that this difference was significant enough that the index fund positions would not qualify for a hedge exemption. Nevertheless, because the index fund positions represented a legitimate and potentially useful investment strategy, Commission staff granted the index funds no-action relief, subject to certain conditions intended to protect the futures markets from potential ill effects. These conditions included: (1) The positions must be passively managed: (2) They must be unleveraged (so that financial conditions should not trigger rapid liquidations); and (3) the positions must not be carried into the delivery month (when physical delivery markets are most vulnerable to manipulation or congestion).