U.S. COMMODITY FUTURES TRADING COMMISSION
ENSURING THE INTEGRITY OF THE FUTURES & OPTIONS MARKETS

SPEECHES & TESTIMONY

Statement of Dissent by Commissioner Scott D. O'Malia, Notice of Proposed Rulemaking for Position Limits for Derivatives

CFTC Open Meeting

November 5, 2013

I respectfully dissent from the Commission's decision to approve the Notice of Proposed Rulemaking for Position Limits for Derivatives. I have a number of serious concerns with the position limits proposed rule and its interpretation of section 4a(a) of the Commodity Exchange Act ("CEA" or "Act").[1] Regrettably, this proposal continues to chip away at the commercial and business operations of end-users and the vital hedging function of the futures and swaps markets.

I cannot support the position limits proposed rule that is before the Commission today because the proposal: (1) fails to utilize current, forward-looking data and other empirical evidence as a justification for position limits; (2) fails to provide enough flexibility for commercial end-users to engage in necessary hedging activities; and (3) fails to establish a useful process for end-users to seek hedging exemptions.

We Are the Experts, But Where's the Evidence?

Recently, in connection with the Commission's vote to dismiss its appeal[2] of the vacated 2011 position limits rule,[3] I reiterated that the federal district court[4] had instructed the Commission to go back to the drawing board and do its homework.[5] As I have consistently stated, the Commission must perform a rigorous and objective fact-based analysis in order to determine whether position limits will effectively prevent or deter excessive speculation.[6] Not only that, but the Commission must also, in establishing any limits, ensure that there is sufficient market liquidity for hedgers and prevent disruption of the price discovery function of the underlying market. Unfortunately, the position limits rule that is being proposed today is not based upon a careful, disciplined review of market dynamics or the new data collected under our expanded oversight responsibilities provided for by the Dodd-Frank Act.[7]

In its second attempt at establishing a broad position limit regime that is in accordance with the statutory language amended by Dodd-Frank, the Commission relies on a new legal strategy—but not new data—in order to circumvent the spirit of the district court's decision. Surprisingly, the Commission now accepts that the statutory language in CEA section 4a(a)(1)[8] is ambiguous and that there is not a clear mandate from Congress to set position limits, contrary to the arguments made by the Commission both in court and in the vacated rule. Notwithstanding that concession, the proposed rule now hides behind *Chevron* deference and invokes the Commission's "experience and expertise" in order to justify setting position limits without performing an ex ante analysis using current market data.[9]

I am troubled that the proposal uses only two examples from the past—one of them as far back as the 1970s—to cobble together a weak, after-the-fact justification that position limits would have prevented market disruption. This is glaringly insufficient. Instead, the Commission should have taken the time to analyze the new data, especially from the swaps market, that has been collected under the Dodd-Frank Act. It is especially troubling that the large trader data being reported under Part 20 of Commission regulations[10] is still unreliable and unsuitable for setting position limit levels, almost two full years after entities began reporting data, and that we are forced to resort to using data from 2011 and 2012 as a poor and inexact substitute.

Today, the Commission proposes to set position limits for the futures and swaps markets *in the future*, not the past. I fail to see how we can be "experts" if we do not have the data to back us up. I fear that this reliance on a new legal strategy, instead of evidence-based standards, does little to affirm the Commission's self-proclaimed "expertise" and could result in another long and costly court challenge that will strain our limited resources.

Preserving Flexibility for Commercial End-Users

I am also concerned that the position limits proposed rule may not preserve enough flexibility for commercial end-users to hedge risks inherent in their business operations. Hedging is the foundation of our markets, and the intent of the Dodd-Frank Act was not to place excessive and unnecessary new regulatory burdens on end-users and make it more complicated and more costly to undertake risk management. That was strongly underlined in the letter sent to the Commission by Senators Dodd and Lincoln in June 2010.[11]

Regrettably, the Commission's rules implementing Dodd-Frank have not adhered to that directive. This position limits proposal is just the latest in this disturbing trend of narrowly interpreting the statute to foreclose viable risk management functions that did not contribute to the financial crisis. This trend is nowhere more apparent than in how narrowly the proposal defines the concept of bona fide hedging.

The position limits proposed rule does away with Commission regulation 1.3(z),[12] which has been in effect since the 1970s, and sets forth new regulations that narrow the bona fide hedging definition, in particular the treatment of anticipatory hedging. This is despite the fact that the vacated position limits rule explicitly recognized certain anticipatory hedging transactions as falling within the statutory definition of bona fide hedging and consistent with the purposes of section 4a of the Act, and provided exemptions for such transactions given the condition that the trader was "reasonably certain" of engaging in the anticipated activity. In this proposal, based on an unsatisfactory "further review," the Commission has changed its mind and has scaled back exemptions for anticipatory hedging. In all, the Commission has rejected half of the common hedging scenarios described by a working group of end-users in their petition for exemption.

I question whether the Commission has fulfilled Congress' intent to protect end-users by proposing a new position limits rule that articulates a far too narrow conception of bona fide hedging and does not reflect the realities of end-users' commercial and business operations.

A Workable, Practical Process for Non-Enumerated Hedging Exemptions

I am especially troubled by the proposed rule's elimination of Commission regulations 1.3(z)(3) and 1.47,[13] which is the framework for market participants to seek a non-enumerated hedging exemption. I question whether eliminating a workable, practical process that has been outlined in Commission regulations for decades will make it more difficult for end-users to seek exemptions for legitimate hedging transactions and will cause unnecessary delay and interference with business operations.

Aggregation Proposed Rule

While I believe that today's aggregation proposed rule is more responsive than the vacated rule to the realities that market participants face in their utilization of the futures and swaps markets, some important concerns still remain.

First, the aggregation standards in the proposal present significant technology challenges for compliance, especially across affiliates. I would support a phase-in period to meet those challenges.

Second, I am concerned that there is insufficient consideration and flexibility in the ownership tiers that are used as a proxy for control. I would be interested in reviewing comments on pro rata aggregation, banding/tiering of ownership interest instead of full aggregation, and other issues with beneficial ownership. Further, I question whether the possible exemption for ownership in excess of 50% is of use to any market participants, given the additional conditions that are imposed.

Cost-Benefit Considerations

It is imperative that market participants carefully review the new position limits and aggregation proposed rules and provide comments. I especially encourage market participants to include any comments on the cost impact of the proposed position limits. I would also like to receive input from market participants about the cost of changes to their operations that were undertaken in order to prepare for compliance with the previous position limit rules, before those rules were vacated by the court. While the Commission failed to give enough weight to these consequences, I intend to carefully consider the comments and the critical information they provide in evaluating any draft final rule put before the Commission.

Conclusion

It is rare to get a second chance to do things right. I am disappointed by the Commission's approach today because the Commission has not taken advantage of the opportunity for a second chance presented by the district court decision to vacate the 2011 position limits rule. The Commission has failed in its duty as a responsible market regulator by not taking the time to gather the evidence and establish sound justifications for position limits ex ante that are based on data. Because of this failure, as well as the narrowing of the bona fide hedging definition and the elimination of the existing process for end-users to seek non-enumerated hedging exemptions, I cannot support this proposal.

[1] 7 U.S.C. § 6a(a).

[2] *ISDA & SIFMA v. CFTC*, No. 12-5362 (D.C. Cir.).

[3] 76 Fed. Reg. 71626 (Nov. 18, 2011).

[4] *Int'l Swaps & Derivatives Ass'n v. CFTC*, 887 F. Supp. 2d 259, 280-82 (D.D.C. 2012).

[5] **http://www.cftc.gov/PressRoom/SpeechesTestimony/omaliastatement102913**.

[6] **http://www.cftc.gov/PressRoom/SpeechesTestimony/omaliadissentstatement111512**.

[7] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

[8] 7 U.S.C. § 6a(a)(1).

[9] NPRM pp. 12-14, 24, 32, 171.

[10] 17 C.F.R. part 20.

[11] Letter from Chairman Christopher Dodd, Committee on Banking, Housing, and Urban Affairs, United States Senate, and Chairman Blanche Lincoln, Committee on Agriculture, Nutrition, and Forestry, United States Senate, to Chairman Barney Frank, Financial Services Committee, United States House of Representatives, and Chairman Colin Peterson, Committee on Agriculture, United States House of Representatives (June 30, 2010).

[12] 17 C.F.R. 1.3(z).

[13] 17 C.F.R. 1.3(z)(3) and 1.47.

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