CITADEL

August 4, 2014

Via Electronic Submission: http://comments.cftc.gov

Ms. Melissa Jurgens
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Position Limits for Derivatives (RIN 3038-AD99)

Dear Ms. Jurgens:

Citadel LLC[1] ("Citadel") appreciates the opportunity to provide further comments to the Commodity Futures Trading Commission (the "Commission") on its notice of proposed rulemaking on *Position Limits for Derivatives* (the "Proposed Rule").[2] These comments supplement and expand upon our earlier comment letter dated February 10, 2014 (the "February Letter").[3] We continue to have strong reservations about the necessity, efficacy, and unintended consequences of the proposed position limits. We wish to emphasize, however, that if implemented, at a minimum the rules must be applied in a fair and equal manner to all market participants. Significantly, the approach taken with respect to commodity index contracts and cross-commodity netting in the proposed rules results in disparate treatment across market participants that will introduce distortions in the marketplace, harm liquidity and the price discovery process, and undermine the very objectives the Commission is seeking to achieve.

Commodity Index Contracts

In our February Letter, we stated that if the Commission proceeds with position limits on

[1] Established in 1990, Citadel is a leading global financial institution that provides asset management and capital markets services. With over 1,100 employees globally, Citadel serves a diversified client base through its offices in the world's major financial centers including Chicago, New York, London, Hong Kong, San Francisco and Boston.

[2] Position Limits for Derivatives, 78 Fed. Reg. 75,680 (proposed Dec. 12, 2013), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-27200a.pdf.

[3] *Available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59717

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cash-settled contracts, it should do so consistently across relevant products, including commodity index swaps. Further, we noted that in some commodity markets, commodity index swap activity drives a material percentage of the market turnover. We expressed concern that the disparate treatment of commodity index swaps will yield a number of unintended consequences under the proposed position limits regime, including shifting more trading activity into index swaps, draining liquidity from exchange-listed products, harming pre-trade transparency and the price discovery process, and further depressing open interest (as volumes shift to index swap positions that do not count towards open interest calculations).

Despite the inclusion of swaps that are economically equivalent to referenced futures contracts within the proposed position limits, the Proposed Rule excludes any commodity index contracts from the proposed position limits, even commodity index swaps that are economically equivalent to a basket of referenced futures contracts. If the policy intent of this proposed treatment of commodity index contracts is to limit the index exposure that finds its way to referenced futures contracts, we believe it will actually have the opposite effect, and instead will exacerbate the impact of commodity index exposure on referenced futures contracts.

Statutory and Regulatory Background

Prior to the passage of the Dodd-Frank Act, swaps generally did not fall under the regulatory purview of the Commission, nor were they included in any exchange or federal position limits that existed. Therefore, a swap dealer looking to hedge the exposure of a swap portfolio with futures contracts may have needed an exemption from any existing position limits on the futures contracts to effectively manage that risk. Historically, such an exemption, commonly referred to as a "risk management exemption," was available through an exchange or Commission approval process and allowed a swap dealer to exceed one or more applicable position limits.

In the Dodd-Frank Act, Congress amended the Commodity Exchange Act to add a definition of bona fide hedge exemption for non-excluded commodities. The new definition differed from the definition previously in effect under CFTC rule 1.3(z)(i), by, among others, removing the word "normally" from the phrase "a transaction that ~~normally~~ represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel."[4] The deletion of the word "normally" led the Commission to interpret that the risk management exemption should no longer be available, in order to place limits on the ability of a swap dealer to otherwise lay off an unlimited amount of risk from a swaps portfolio in the underlying futures contract, artificially driving up prices and impairing price discovery. We agree with the interpretation that the risk management exemption should no longer be available – and in fact, the exemption will no longer be necessary because under the Proposed Rule, position limits apply to futures and economically equivalent swaps and the two can be netted for compliance with

[4] *See* CEA Section 4(a)(c)(2)(A)(i).

the position limits.

We agree with the Commission that allowing unlimited commodity index exposure to make its way to the underlying futures contracts would artificially drive up prices and impair price discovery. However, we do not believe that the approach of exempting commodity index contracts from the proposed position limits achieves the goal of limiting the flow of commodity index exposure to the referenced futures contracts.

Implications of Proposed Treatment

The exemption of commodity index contracts from the proposed position limits, in conjunction with the elimination of the risk management exemption, does achieve the goal of limiting the amount of commodity index swap exposure that any single swap dealer can lay off in the underlying referenced futures contracts (because position limits apply to that swap dealer's futures positions and no offset is recognized for its offsetting commodity index swap positions). However, because commodity index contracts themselves are exempt from the proposed position limits, demand for exposure to the referenced futures contracts on the investor side remains uncapped.

This demand can and will continue to flow to the underlying referenced futures contracts as new intermediaries beyond traditional swap dealers step into the space and satisfy uncapped investor demand for commodity index exposure. The universe of potential intermediaries that can facilitate this process is not limited in any meaningful way and any number of market participants can fill the void. Thus, attempting to limit the flow of commodity index exposure to the referenced futures contracts by limiting what any individual intermediary can accommodate will not be successful. Rather, it results in there being no limit on the amount of commodity index exposure that can be laid off in the referenced futures contracts. The only limit that thus exists under the Proposed Rule is the saturation of investor demand, as we believe there are an effectively unlimited number of intermediaries willing to offer this service as long as demand exists.

Recommended Alternative

Assuming the Commission proceeds with implementing the proposed position limits, our recommended alternative is to include exposure obtained through commodity index contracts themselves under the limits. We concede that this alternative would allow a single swap dealer to net an unlimited amount of commodity index contract exposure against positions in the underlying referenced futures contracts.[5] However, the proposed position limits would then apply to the ultimate investors, thereby creating a more effective overall limit on commodity index exposure.

[5] This occurs independently of the elimination of the risk management exemption.

We believe that this is the only approach that will achieve the policy goal of limiting the amount of commodity index exposure ultimately reflected in the price of the underlying referenced futures contracts.

Cross-Commodity Netting

In our February Letter, we recommended that all market participants should be able to recognize offsets between highly correlated commodities, to better reflect how market participants actually manage risk, more accurately account for market participants' true risk positions and ability to affect the market, avoid disparate treatment of different market participants, and avoid concentrating cross-commodity risk exposures in a narrower universe of market participants.

As an example, a market participant that wants to hedge its physical exposure in Kansas City Wheat will often do so with a Chicago Wheat contract, given the superior liquidity of the latter. However, when this happens, another market participant needs to step in to provide liquidity by taking a position between the Kansas City Wheat and Chicago Wheat contracts. Similar situations occurs in many markets, including forward purchases or sales of Heating Oil or Gasoline from refiners or consumers that for purposes of liquidity and risk management will often be hedged with Crude Oil contracts.

The Proposed Rule sensibly recognizes offsets between such highly correlated commodities, but then only allows such offsets to be recognized by market participants that qualify for a bona fide hedge exemption, such as the first market participant in the example above. The second market participant would not receive the same netting treatment, even though the economic exposure mirrors that of the first participant. We believe that the cross-commodity netting treatment accorded in this case to the first market participant should be available to all market participants to prevent asymmetries and distortions in the market.

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In conclusion, we believe that disparate treatment of different types of market participants, otherwise engaged in similar forms of trading activity, is not justified. If implemented, the Commission must ensure that any speculative position limits apply equally to the speculative activity of all market participants, and do not discriminate among them. Modifying the proposed treatment of commodity index contracts and cross-commodity netting would help ensure a fairer more equal application of any speculative position limits.

We appreciate the opportunity to provide further comments on the Proposed Rule. Please feel free to call the undersigned at (312) 395-3100 with any questions regarding these comments.

Respectfully,

/s/ Adam C. Cooper
Senior Managing Director and Chief Legal Officer