



Comment on “Notice of Proposed Rulemaking: Aggregation of Positions”, 17 CFR Part 150 (RIN 3038-AD82)<sup>1</sup>

Commodity Futures Trading Commission (“CFTC” “Commission”)

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February 10, 2014

Submitted electronically

The Institute for Agriculture and Trade Policy (IATP) appreciates this second opportunity to comment on the aggregation of data within its revised position limits rule. IATP thanks the CFTC for its consideration of our June 29, 2012 comments on aggregation standards<sup>3</sup> and will not, with two exceptions, reiterate those comments here. The following response is comprised of a general comment on what we understand to be the overall logic of the Commission proposed “relaxation of historical practice” to allow case by case exemptions from aggregation (FR, 68968) and specific responses to proposed provisions for different kinds of exemptive relief.

*General comment*

As the CFTC states at the outset of this “Notice of proposed rulemaking”, rules on position aggregation is a third pillar of the position limits regime (FR 68946). If exemptions to aggregation are pervasive, position data will be inadequate to determine compliance with the position limit rule. The aggregation pillar will collapse and with it the efficacy of the position limits regime to prevent, diminish and if possible, eliminate excessive speculation. Given that several of the commenters proposing broad and new exemptions belong to the plaintiff organizations seeking to prevent the implementation of the position limit rule revised under the authority of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA)<sup>4</sup>, the CFTC has been very generous in proposing to accommodate industry demands for exemptive relief. The CFTC notes several times that the granting of exemptions is conditioned not only on the applicant’s demonstration of compliance with the criteria for the applicable exemption upon filing a memorandum of law by the applicant’s internal counsel, but that continued compliance to qualify for the exemption must be demonstrated (FR 68947, 68960 et passim).

Nevertheless, precisely because comprehensive aggregation of position data is a core component of the position limit regime, IATP believes that the revision of the aggregation rule should require the CFTC to publish a study on the effect of aggregation exemptions on the efficacy of the position limit regime. The study should be produced no later than two years after the promulgation of the aggregation rule. Such a study should aid the CFTC when it reviews both spot and non-spot month position limits to determine whether the quantitative levels of position control are adequate to prevent and diminish excessive speculation, as required by the DFA. (IATP continues to advocate annual review of position limits. However, we recognize that those opposed to the implementation

and enforcement of the DFA will continue to constrain the Commission's budget to the point where an annual review of position limits may not be feasible.<sup>5)</sup>

One category of aggregation exemption concerns the degree of ownership that qualifies a person to apply for the "owned entity exemption". The logic of this exemption is that degree of ownership is a proxy for the likelihood of coordinated trading strategies that could circumvent position limits and result in excessive speculation in the covered contracts. The great new regulatory challenge for the Commission, concerning the "easily administrable bright line test" (FR 68951) it proposes in the revised owned entity exemption, is the massive and growing prevalence of Automated Trading Systems (ATSs) in commodity derivatives markets.<sup>6</sup> While High Frequency Trading positions are intra-day and therefore not captured by the position limit rule, other ATS positions remain open at the end of the trading day and hence fall under the jurisdiction of the position limit rule.

When the CFTC developed its aggregation rule for pre-ATS practices (i.e., "open outcry" and specialist dominated) applied to the nine legacy agricultural contracts, intent and effect in coordinated strategies was easier to determine because of the much greater degree of human intervention in trading decisions. Now, however, it will be more difficult for the Commission to validate an aggregation exemption on condition that owned entities of the person receiving the exemption "not have knowledge of the trading decisions of the other" (Part 150.4.2.ii.b, FR 68978). If a "trading decision" is a transaction triggered by a third party algorithm over which human intervention is exercised only in cases of massive algorithm malfunction (i.e. flash crashes), how is "knowledge of trading decisions" to be demonstrated to satisfy that "not have knowledge of" criterion for granting the exemption from aggregation?

The agency is well aware of the limitations of a "bright line test" for determining how an owned entity exemption from aggregation position reporting could be used to circumvent position limits. The common use of "off the shelf" third party ATS algorithms by entities owned by one or more higher tier entities could enable a de facto coordination of trading strategies without any indication in reported positions of intent to do so. As the "Notice of proposed rulemaking states," "the Commission's concern is that trading systems (in particular the parameters for trading that are applied by the systems) could be used by multiple parties who know that the other parties are using the same trading system as well as the specific parameters used for trading, and therefore are indirectly coordinating their trading" (FR, 68962).

Notwithstanding the Commission's concern and awareness of the challenge that ATS presents to position data surveillance, we do not read in the proposed rule adequate regulatory measures to prevent and diminish the likelihood of such indirect and automated coordination. In view of the dominance of ATS practices, the Commission should consider whether terms such as "trading decision" and "indirect coordination" require regulatory specification.

Commodity specific provisions within a rule resulting from the CFTC's Concept Release on ATS and HFT may provide regulatory measures to prevent automated circumvention of the position limits regime. But as we have noted in previous comments to the Commission, the interface between commodity derivatives and ATS and HFT practices has yet to be addressed by the Commission or by its advisory committees.<sup>7</sup> Joint meetings of representatives of the Technology Advisory Committee, the Agricultural Advisory Committee and the Energy and Environmental Markets Advisory Committee, with cutting edge presentations by non-industry experts, could assist the Commission in its work.

### *Specific proposed exemptions to position aggregation*

1. CFTC's administrative burden under the proposed exemptions: exemption for information sharing restriction

Like the Commission, IATP is concerned about the Commission's administrative burden of processing the applications for exemptions from aggregation and of monitoring compliance with grants of exemptive relief under this and other DFA authorized rules. Streamlined administration of narrow, clear and well-justified exemptions is crucial for the effective enforcement of the position limits regime, particularly given the budgetary and policy hostility of much of the derivatives industry and its Congressional sympathizers to implementation and enforcement of Title VII of the DFA.<sup>8</sup>

The Commission has sought to limit this burden by wisely declining industry proposals that would have had the CFTC reviewing claims that aggregation requirements might violate local laws and international treaties (FR 68950). The CFTC likewise declined as "inefficient and impractical" (FR 68959) an industry proposal to shift the burden of demonstrating compliance with the aggregation rule from the industry to the Commission.

Since industry petitioners provided no examples of potential violations of law due to position aggregation, it is not clear what the specific violations might be. However, the industry's general concern, as we understand it, is that aggregation of data for regulatory compliance will leave the owned trading entity and the higher tier "passive" owner legally liable to possible misuse of the aggregated position data by the trading desks of the owned entities. It appears that some commenters are proposing to pre-empt violations of aggregation rules by their trading desks by allowing more and broader exemptions from compliance with the aggregation of positions.

The Commission has usefully provided a chart detailing "the relatively small number of persons that held positions over the applicable limit [for nine agricultural legacy contracts] during the period of January 17, 2012 to September 30, 2012" (FR 68957). The purpose of the agency's chart of entities exceeding the legacy limits is to suggest that after the granting of aggregation exemptions the "relatively small number of persons" (about 400 for the spot month) will be even fewer.

However, with the expansion in the application of the position limits rule from the nine legacy contracts for which the CFTC has position data to the additional 19 contracts to be covered in the position limit rule, this "relatively small number of persons" surely will increase, even taking into account compliance with position limits by entities benefiting from aggregation exemptions. The Commission's explanation of its aggregation rule assures commenters that "it will not result in a significantly increased level of information sharing that would result in increased coordinated speculative trading" (FR 68957).

IATP does not believe that the Commission needs to or should provide such assurance. Rather, if information sharing by an entity and its affiliates and subsidiaries increases as a result of the entity's decisions to trade in the formerly exempt contracts now covered by the position limit rule, it is the higher tier entity's obligation to ensure that information shared among owned entities to comply with the position limits regime not be used to coordinate speculative trading. Again, the burden of compliance is on those persons covered by the aggregation rule, not on the Commission.

The proposed rule exempts entities from aggregating positions if doing so would violate a state, federal or foreign law or regulation (Part 150.4.b.8). However, that paragraph continues, “the exemption in this law or regulation shall not apply where the law or regulation serves as a means to evade the aggregation of accounts or positions” (FR 68978). IATP strongly agrees with this clarification, particularly considering the number of comments from foreign governments and foreign banks with U.S. affiliates that alleged the Commission’s cross-border guidance could violate their data privacy laws.

Indeed, given the complex and often global structure of the larger entities covered by this rule<sup>9</sup>, IATP believes that Part 150.4b should include a sentence to the effect that none of the exemptions from aggregation may be used as a means to evade compliance with the position limits regime. The Commission’s administrative burden to review applications for exemption and to monitor compliance with the applicable exemptions is already great. A warning to entities at the outset of the rule concerning the prohibition of using aggregation exemptions to evade the position limits regime might serve to reduce the Commission’s administrative burden in reviewing applications and monitoring compliance with the applicable exemption.

Finally, given the possibility that an applicant could seek to avoid aggregation by claiming that to do so would create a “reasonable risk” of violating a foreign law, e.g. concerning the data privacy of positions held by an entity’s individual clients, the Commission should consider the effect of granting foreign law based exemptions on cross-border compliance. The seven largest U.S. headquartered bank holding companies, all major swaps dealers, have about 5,700 foreign subsidiaries in dozens of foreign jurisdictions.<sup>10</sup> The Commission should outline in the rule measures to reduce the Commission’s administrative burden that applications for multiple exemptions from aggregation from multiple jurisdictions will present. Memoranda of Understanding with foreign jurisdiction authorities concerning the criteria for substituted compliance for aggregation exemptions may reduce this burden.

However, few, if any, of the Group of 20 jurisdictions have aggregation rules in place. IATP urges the Commission to participate in and publicize the results of the Financial Stability Board’s feasibility study of a global template for aggregating Over the Counter trading data.<sup>11</sup> The February 4 release of the FSB consultation paper on data aggregation will afford the Commission and interested stakeholders the opportunity to comment and ensure that CFTC aggregation standards lead the global consensus on regulatory means to prevent aggregation circumvention.<sup>12</sup>

## 2. Exemption for broker-dealer activity

This exemption from aggregation is tailored for higher-tiered entities that acquire “in the normal course of business as a dealer” (Part 150.4.b.7, FR 68977) a less than 50 percent equity based share of an entity that trades OTC derivative positions. The Commission would grant the exemption to dealers registered with the Securities Exchange Commission “or similarly registered with a foreign regulatory authority” “*provided that* [emphasis in the original] such person does not have actual knowledge of the trading decisions of the owned entity.” The rationale for this exemption should be expanded and clarified.

If a broker-dealer becomes an owner with a substantial but not controlling interest in a derivatives trading entity, due diligence during the research phase of purchasing the owned entity will have revealed historical knowledge of the owned entity’s trading strategies and major trading decisions. The proviso exempting the broker-dealer is conditioned upon acquiring no further knowledge of the

owned entities' trading decisions. We understand "actual knowledge" in the proposed rule to mean not just "knowledge contemporaneous with the moment of acquisition" but contemporaneous with any knowledge of any trading decisions by the newly acquired entity and other entities in which the broker dealer has an equity based interest. But our understanding well may be inaccurate, so IATP requests that the Commission provide further detail about what constitutes "actual knowledge" in the rule.

In general, IATP believes that a higher-tier entity that is zealous in tracking the trading revenues and profits of owned entities should be equally, if not more, zealous in ensuring that the owned entities comply with the rules pertaining to the activities through which those revenues and profits are earned. We hope that the Commission agrees with this belief and will express that belief in the rule.

### 3. Notice of filing for exemption

In a comment on the Commission's Concept Release for possible rulemaking on ATS and HFT, IATP argued for a dual attestation as to who should self-certify that an entity trading through ATS and/HFT had in place and had tested pre-trade and post-trade risk controls, as well as system wide controls.<sup>13</sup> IATP contends that to increase the comprehensiveness of compliance with Commission rules, attestation by the chief executive officer and the chief compliance officer or chief of risk management is needed. We believe that among the firms that New York Federal Reserve President William Dudley characterized as having little respect for the law,<sup>14</sup> it is particularly important to instill a culture of compliance by ensuring that the chief executive officer regards the compliance department as an essential part of the firm's business model and not a burden to be suffered or a cost to be reduced.

The proposed "Notice of filing for exemption" (FR 68978) from aggregating positions simply requires a "statement of a senior officer" that the applicant for exemption meets all the requirements to be granted the exemption. If there is a "material change" in the information provided in the statement, an updating or amending of the original statement may be provided anonymously. IATP believes that this manner of filing for an exemption from aggregation will appear to be casual to the applicant, who may as a result assume that the granting of the exemption will be routine.

The CFTC should revise the notice of filing for the exemption and the amending of the filing to ensure that the applicant understands that the CFTC views exemptions from aggregation as exceptional departures from aggregation. Applications for such exemptions should require the involvement and certification of the applicant's chief executive officer and chief compliance officer. Otherwise, if the application were inaccurate or incomplete, the privilege of exemption could be lost due to an application prepared by internal legal counsel but without the review and signature of an entity's most competent compliance authority and that authority's supervisor.

### Conclusion

A plethora of exemptions, exclusions and waivers from compliance with CFTC rules, and indeed with prudential regulation in all the financial regulatory agencies, characterized the OTC de- and non-regulated trading environment prior to the beginning of implementation of the DFA. Notwithstanding the legal challenges to CFTC rulemaking and the barrage of Congressional attacks on the DFA and the Commission's budget and morale, the CFTC has worked with patience, creativity, intellectual integrity and courage to implement the DFA. Our criticisms of some aspects

of this rulemaking in no way diminishes our immense respect for the Commission, its staff and the way it has carried out its mission in a hostile political and budgetary environment. IATP looks forward to helping the CFTC realize that mission, to the extent of our capacity and resources.

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<sup>1</sup> <http://www.cftc.gov/ucm/groups/public/@lfederalregister/documents/file/2013-27339a.pdf>

<sup>2</sup> IATP is a nonprofit, 501(c)(3) nongovernmental organization, headquartered in Minneapolis, Minn., with an office in Washington, D.C. Our mission states, “The Institute for Agriculture and Trade Policy works locally and globally at the intersection of policy and practice to ensure fair and sustainable food, farm and trade systems.” To carry out this mission, as regards commodity market regulation, IATP has participated in the Commodity Markets Oversight Coalition (CMOC) since 2009, and the Derivatives Task Force of Americans for Financial Reform since 2010. IATP has submitted several comments on CFTC rulemaking, and on consultation papers of the International Organization of Securities Commissions, the European Securities and Markets Authority, and the European Commission’s Directorate General for Internal Markets.

<sup>3</sup> <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58293&SearchText=>

<sup>4</sup> International Swaps and Derivatives Association and Securities Industry and Financial Markets Association v. Commodity Futures Trading Commission, United States Court of Appeals for the District of Columbia Circuit, USCA Case # 12-5362. IATP strongly supports the CMOC’s amicus curiae brief in support of the CFTC’s appeal of the adverse district court ruling against the position limit rule. See <http://www.nefiactioncenter.com/PDF/cmocfiledamicusbrief.pdf>

<sup>5</sup> Robert Schmidt and Silla Brush, “Budget Woes Leave U.S. Swaps Agency Outgunned by Wall Street”, Bloomberg News, January 17, 2014.

<sup>6</sup> E.g. David Bicchetti and Nicolas Maystre, “The synchronized and long-lasting change on commodity markets: evidence from high-frequency data,” Munich Personal RePEc Archive, March 2012. <http://mpira.ub.uni-7muenchen.de/37486>

<sup>7</sup> <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59442&SearchText=>

<sup>8</sup> E.g., Dan Roberts, “Democrats concede to curb funds for Wall Street regulators,” *The Guardian*, January 14, 2014.

<sup>9</sup> E.g. Dafna Avraham, Patricia Selvaggi and James Vickery, “A Structural View of U.S. Bank Holding Companies”, *FBRNY Economic Policy Review*, July 2012. <http://www.newyorkfed.org/research/epr/12v18n2/1207avra.pdf>

<sup>10</sup> Avraham et al. *Op cit.*, Table 1: “Number and distribution of subsidiaries: Selected Top 50 Bank Holding Companies”, 71.

<sup>11</sup> Press release, “Meeting of the Financial Stability Board in Basel, June 24, 2013. Financial Stability Board. [http://www.financialstabilityboard.org/press/pr\\_130625.pdf](http://www.financialstabilityboard.org/press/pr_130625.pdf)

<sup>12</sup> [http://www.financialstabilityboard.org/publications/r\\_140204.htm](http://www.financialstabilityboard.org/publications/r_140204.htm)

<sup>13</sup> <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59442&SearchText=>

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<sup>14</sup> Shahien Nasiripour, “New York Fed Chief Levels Explosive Charges Against Big Banks”, Huffington Post, November 8, 2013. [http://www.huffingtonpost.com/2013/11/07/william-dudley-big-banks\\_n\\_4235834.html](http://www.huffingtonpost.com/2013/11/07/william-dudley-big-banks_n_4235834.html)