March 28, 2011

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

Dear Mr. Stawick:

The World Gold Council respectfully submits to the Commodity Futures Trading Commission (the "CFTC") the following comments and recommendations in response to the Federal Register Notice of January 26, 2011[1] that pertains to the notice of proposed rulemaking to establish position limits for certain physical commodity derivatives (the "Proposed Rule") pursuant to Section 737 of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

The World Gold Council is the market development organization for the gold industry. Working within the investment, jewelry and technology sectors, as well as engaging in government affairs, the purpose of the World Gold Council is to provide industry leadership, while stimulating and sustaining demand for gold.

Established in 1987, the World Gold Council is a leading authority on the international gold markets, helping people to better understand the wealth preservation qualities of gold and its role in meeting the social and environmental needs of society. In this capacity, the World Gold Council has a strong interest in fair and transparent markets, and in ensuring that nothing threatens the liquidity of those markets.

Although the World Gold Council acknowledges the importance of the Dodd-Frank Act's goal to, among other things, reduce systemic risk in the U.S. financial system, the World Gold Council is concerned that the Proposed Rule extends beyond the legislative intent of the Act and, if implemented, could reduce or impair liquidity and trade in the gold market, an asset that has been a trusted commodity for governments, financial institutions, and the general public for centuries.

I. Insufficient Legal Basis for Imposition of Position Limits

The CFTC's position regarding its ability to impose position limits without establishing that position limits are necessary to diminish, eliminate, or prevent burdens on interstate commerce is inconsistent with the plain language of the Commodity Exchange Act, as amended by the Dodd-Frank Act ("CEA"). Under Section 4a(a)(2) of the CEA, the CFTC has the authority to establish, "as appropriate," limits on speculative positions in derivatives contracts where such limits are "necessary to diminish, eliminate or prevent" the burden on interstate commerce caused by excessive speculation.[2] Whether or not it is due to a lack of evidence indicating a causal relationship between the actions of speculators and the price/volatility in the commodities markets, the CFTC has interpreted CEA Section 4a(a)(2) in a

[1] FR Vol. 76, No. 17, pages 4752-4777

[2] 7 U.S.C. 4a(a)(2)

manner that does not require evidence that excessive speculation exists or is likely to occur in the future in order to impose position limits.[3] The CFTC has stated that CEA Section 4a(a)(2) allows it to "impose position limits prophylactically, based on its reasonable judgment that such limits are necessary . . . ."[4] However, CEA Section 4a(a)(1) expressly establishes the CFTC's obligation with respect to position limits:

> [T]he Commission shall . . . fix such limits . . . *as the Commission **finds are necessary*** to diminish, eliminate, or prevent such burden."[5]

CEA Section 4a(a)(1) does not provide that the CFTC may fix position limits "prophylactically, based on its reasonable judgment that such limits are necessary." On the contrary, the plain language of CEA Section 4a(a)(1) requires that the CFTC make a finding that the proposed position limits are "necessary" to diminish, eliminate, or prevent excessive speculation. Absent such a "necessary" finding and supporting evidence explaining why particular position limits are "necessary", the World Gold Council believes that the CFTC lacks statutory authority to set position limits.

Additionally, the lack of such "necessary" finding or evidence makes it difficult for the World Gold Council to adequately address the CFTC's rationale for imposing position limits on Reference Contracts relating to gold. The World Gold Council would like the ability to comment on the specific factual basis or substantive analysis by the CFTC which it uses to support its "reasonable judgment" that the proposed position limits are "necessary to diminish, eliminate or prevent" excessive speculation or otherwise "appropriate." Without making the necessary findings with respect to the necessity of position limits for Reference Contracts related to gold, the CFTC will not have provided an objectively reviewable basis for concluding that the proposed position limits are needed to prevent market manipulation, ensure sufficient market liquidity, and ensure that price discovery is not disrupted. As Commissioner Dunn publicly stated at the CFTC's January 13 meeting: "With such a lack of concrete economic evidence, my fear is that, at best, position limits are a cure for a disease that does not exist or at worst, a placebo for one that does." The World Gold Council shares Commissioner Dunn's concerns with respect to position limits.

Accordingly, the World Gold Council requests that the CFTC withdraw the Proposed Rule until after the CFTC is able to determine whether position limits are, in fact, necessary with respect to each of the Referenced Contracts and their economic equivalents.[6]

However, if the CFTC determines to issue final position limit rules (notwithstanding its questionable authority to do so as currently contemplated), the World Gold Council requests that the CFTC consider the comments listed below in connection with final position limit rules.

II. Gold is Fundamentally Different from other Commodities

The World Gold Council submits that gold is fundamentally different from the other commodities referenced in the Proposed Rule and, therefore, the Reference Contracts related to gold should be

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[3] 76 Fed. Reg. at 4,754.

[4] *Id*.

[5] CEA § 4a(a)(1) (emphasis added).

[6] Furthermore, the lack of such findings and analysis prevents us from adequately addressing the CFTC's rational for position limits as it applies to the gold market.

excluded from any position limits under the Proposed Rule.[7] Further, the Proposed Rule's one-size-fits-all approach and inclusion of gold Referenced Contracts may result in unintended harms to the gold market.

A. The Gold Market is Vast

The financial market in gold is large, deep, and among the most liquid of financial assets. Gold trades in an around the clock global market, serving both as a monetary asset as a quasi currency, and as a financial asset as a form of investment. Gold has been used in this manner since as early as 500 BC when the first gold coin was struck. For hundreds of years gold served an important official role in the global monetary system when many countries backed their currencies with gold. While gold no longer has a legal role in the world's monetary system, central banks and governments continue to hold 17.5 percent of all above ground stocks of gold and hold it as one of their largest reserve assets in order to preserve the wealth of society and protect against macroeconomic and financial shocks.[8] Recently, gold's importance to the global economy was noted by the president of the World Bank, Robert Zoellick, who suggested that gold could serve as "an international reference point of market expectations about inflation, deflation and future currency values."

In sharp contrast to most of the other commodities referenced in the Proposed Rule, the vast majority of gold trading takes place in the global over-the-counter wholesale market. World Gold Council research estimates that gold trading in the US futures market would represent only a small component of all global trading in gold, at most 15 percent, with trading volumes dominated by the global wholesale OTC market.[9] Therefore, the presumption that the US gold futures market could distort the pricing and liquidity in the global gold market is very unlikely. Given gold's unique role in the global financial marketplace, the World Gold Council is concerned that the implementation of the Proposed Rule without a sufficient basis that establishes position limits are "necessary" could impact the liquidity of the gold market and could reduce the beneficial qualities of gold to the international monetary and financial systems.

B. Gold is not consumed

Unlike agricultural and energy commodities, gold is not consumed in a normal sense as virtually all of the gold that has ever been mined still exists. The vast majority of gold remains in use in the hands of central banks and governments, financial institutions and other commercial institutions, as well as the general public in the form of jewelry and dentistry. This contrasts significantly with the other commodities potentially subject to position limits, which can be more finite in supply and can spoil or be spent in normal consumption behavior. The existence of large and liquid above ground stocks means the supply of gold to the market does not suffer similar pressures as other commodity markets.

C. Diversity of supply provides stability to the gold market

Gold mine production is derived from numerous separate operations on all continents of the world (other than Antarctica) making it a truly global commodity with limited supply concentration risks in contrast to many other commodities. For example, no single region produces more than 20% of global

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[7] The World Gold Council supports testimony made by HSBC Group to the CFTC on March 25, 2010 and echoes the view that gold should be treated different in the Proposed Rule and the Referenced Contracts related to gold should be excluded from position limits.

[8] GFMS Gold Survey 2010

[9] WGC estimates

mine supply.[10] Therefore, any disruption to production in any one locality is unlikely to affect a significant number of these operations simultaneously. Furthermore, the rapid mobilization of above ground gold stocks from fabricated sources like jewelry can help to support any supply shortages by its re-entry into the market through recycling of gold.

Based on the foregoing, the World Gold Council is concerned that the current one-size-fits-all limits approach does not accurately reflect economically relevant differences between commodities. For example, the rationale is unclear as to why both gold and silver would have the same position limit. COMEX gold has a daily volume approximately four times silver volume, and the open interest in COMEX gold has averaged 3.5 to 4 times the open interest in COMEX silver futures. Without more information and analysis from the CFTC evidencing the negative impacts of speculation on these markets and how position limits will eliminate excess speculation, the World Gold Council questions how such fundamentally different markets fit the current proposed one-size-fits-all model.

III. Appropriate Measure of Deliverable Supply

The Proposed Rule would establish spot-month position limits for the Referenced Contracts and physical commodity swaps that are economically equivalent to the Referenced Contracts based on the estimated deliverable supply for each contract.[11] The CFTC's traditional definition of "deliverable supply" does not accurately reflect ways in which the markets for futures, swaps and other derivatives products have fundamentally changed in the more than twenty years since the CFTC last considered making material changes to the rules governing position limits.[12]

The current proposed definition of "deliverable supply" includes the quantity of the commodity meeting a contract's delivery specifications that a market participant could, with "prudent planning," procure during the relevant time period from available local supply, deliverable non-local supply, and comparable supply (based on factors such as product and location).[13] The World Gold Council believes that the CFTC should update its definition of "deliverable supply" to account for changes in the commodity markets over the last twenty years which have increased the complexities and products within the commodity markets. For example, "exchanges for related positions" ("EFRPs") are transactions used by market participants in the futures exchanges to accommodate more flexible settlement options for physically-settled commodity transactions. An EFRP consists of two discrete but related simultaneous transactions. One party to the EFRP must be the buyer of (or the holder of the long market exposure associated with) the related position and the seller of the corresponding exchange contract. The other party to the EFRP must be the seller of (or the holder of the short market exposure associated with) the related position and the buyer of the corresponding Exchange contract. The related position (cash, OTC swap, OTC option, or other OTC derivative) must involve the commodity underlying the exchange contract, or must be a derivative, by-product, or related product of such commodity that has a reasonable degree of price correlation to the commodity underlying the exchange contract.

[10] GFMS Gold Survey

[11] The Proposed Rule would define "deliverable supply" as: "the quantity of the commodity meeting a derivative contract's delivery specifications that can reasonably be expected to be readily available to short traders and saleable by long traders at its market value in normal cash marketing channels at the derivative contract's delivery points during the specified delivery period, barring abnormal movement in interstate commerce." 76 Fed. Reg. at 4,757.

[12] *See* Revision of Federal Speculative Position Limits, 52 Fed. Reg. 38,914, 38917 (Oct. 20, 1987).

[13] In re Cox, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,786, at 34,062-065 (CFTC Jul. 15, 1987).

In the majority of circumstances, EFRPs (particularly exchange for physical transactions) make physical settlement of exchange-traded commodity futures and option contracts unnecessary, and therefore, increasingly less common. Additionally, the exchange for physical transaction makes a commodity's futures contract substantially less vulnerable to a corner or squeeze because, in effect, the exchange for physical transaction has introduced flexibility to an otherwise limited physical settlement process.

The World Gold Council encourages the CFTC to update the proposed definition of deliverable supply to reflect the more flexible settlement options for physically-settled commodity transactions, and thereby expanding the definition of deliverable supply (and increase the applicable spot-month position limits). Furthermore, an updated definition of deliverable supply which accurately reflects the manner in which the current commodity markets function will reduce the threat of price volatility and manipulation, while promoting liquidity and encourage effective risk management.

IV. Annual Recalculation of Position Limit May Lead to Reduced Liquidity

The CFTC's proposal to recalculate the position limits annually based on changes in open interest potentially may reduce the participation of market participants in the more deferred delivery months, particularly for long-term contracts that include positions in relatively illiquid deferred months. For example, a market participant may be wary of entering into a long-term transaction if the position limit that makes the trade permissible at one point in time may be reduced in the future. In order to secure financing for many mining projects, the World Gold Council's members must be able to hedge price risk many years into the future. However, the uncertainty associated with floating position limits may inadvertently discourage market participants from providing the requisite long-term hedges which, in turn, would make it difficult for the World Gold Council's members to finance investments for crucial infrastructure projects. In general, the annual recalculation will make it difficult to hedge long-term transactions. This, in turn, likely will lead to more price volatility due to reduced liquidity.

The World Gold Council recommends that the CFTC only adjust position limits when necessary, rather than on an automatic, annual basis.

V. Increased Regulatory Burden and Regulatory Arbitrage

The World Gold Council requests that the CFTC reconsider the cost-benefit considerations of the reporting and recordkeeping requirements within the Proposed Rule. The increased regulatory and recordkeeping requirements associated with *bona fide* hedgers and counterparties to *bona fide* hedging transactions may result in a less liquid market with fewer market participants. Capital may leave the market due to regulatory arbitrage, and less capital may enter the market due to the barrier to entry presented by the inability to afford and maintain a compliance program. All of this would result in less competitive, less efficient markets with fewer market participants.

The regulatory and record keeping requirements are varied and complex. In some instances, certain requested information must be reported to the CFTC no later than 9:00 a.m. on the business day following the day position limits were exceeded.[14] Anticipatory hedgers will need to make certain filings at least ten (10) days in advance of the date that the anticipatory hedger will exceed the position limits. Additionally, there are reports which are required to be filed each business day, up to and including the

[14] §§ 151.5(b); 151.5(d)

day after the trader's position level is below the position limit that was exceeded.[15] The potential for being subject to the various reporting requirements is increased due to the proposed aggregation rules. In regards to the costs associated with these new burdens, the CFTC notes that in some instances the "compliance cost associated with all of these filings will be substantial…which may require the collection and storage of information on counterparties that firms have hitherto not conducted."[16]

These regulatory compliance requirements represent a material burden to not only members of the World Gold Council, but the counterparties and financiers of many of our members' hedges. How these increased costs are spread among the various market participants is uncertain, but increased costs, in a market where price parity between the physical price and futures price is fundamental, could have significantly negative consequences. Were the futures price of an underlying commodity to be skewed relative to the physical price of the same commodity, so that the futures price no longer accurately reflects the correct price of the underlying commodity, market participants (such as gold mining companies) may move to new or different markets. Furthermore, the fact that other markets such as those in the United Kingdom appear unlikely to impose position limits, there is an increased likelihood of regulatory arbitrage when other sophisticated markets are readily available to the current U.S. market participants. Having fewer market participants would reduce the liquidity of the market, further exasperating the problem of regulatory arbitrage.

The World Gold Council also requests (assuming the currently proposed regulatory and recordkeeping requirements are implemented as proposed in, or in substantially the same form of, the Proposed Rule) that any of the proposed regulatory and recordkeeping requirements associated with position limits and *bona fide* hedgers be delayed and phased in to the market. This would help ensure that the Proposed Rule results in "sound risk management practices."[17] The required infrastructure to maintain regulatory compliance, in some instances, requires an ability to track, in real-time, various limits in all-months and spot-months, all while tracking and categorizing swaps. This will require substantial initial capital investments by all participants which must be borne along with continuing costs associated with maintaining such an infrastructure. The World Gold Council believes a phased in approach will minimize any sudden shocks to the market resulting from regulatory uncertainty, while ensuring that the members of the World Gold Council can effectively implement and afford appropriate and effective compliance programs and procedures by spreading out the implementation and costs over a period of time.

VI. Anticipatory Hedge Exemption Clarification

The anticipatory hedge exemption as proposed requires that the transaction be renewed each year. The World Gold Council requests clarification regarding this annual renewal requirement and its impact on a Referenced Contract that is a hedge beyond a year, specifically whether gold hedgers will be permitted into anticipatory hedges which have periods greater than one year (*e.g.*, hedges in connection with new mining projects or other large capital investments). The World Gold Council proposes that anticipatory hedges of unsold anticipated commercial production or unfilled anticipated commercial requirements connected to gold Referenced Contracts be excluded from the one-year duration requirements. Excluding gold Referenced Contracts ensures that gold mining companies financing capital heavy long-term transactions can properly hedge the risks associated with these projects.

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[15] § 151.5(i)

[16] 76 Fed. Reg. at 4,766.

[17] A benefit which should be considered when evaluating a new regulation, pursuant to Section 15(a) of the CEA.

VII. Absence of Definition for "Excessive Speculation" Causes Uncertainty in the Market

While the stated intent of the Proposed Rule is for the CFTC to impose position limits that will curb "excessive speculation" in the commodities markets by limiting the positions that can be held by any one trader, the CFTC has not defined the term "excessive speculation" in the Proposed Regulations. Instead, the term is described as "causing sudden or unreasonable fluctuations or unwarranted changes in the price of [a] commodity, [and] is an undue and unnecessary burden on interstate commerce in such commodity."[18] We recommend that the CFTC clearly define the term so that market participants will have a clear understanding of what constitutes "excessive speculation" in the context of the Proposed Rule.

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If you have any questions regarding the above comments and recommendations, please contact me directly on 011 44 207 826 4722.

Sincerely,

[18] FR page 4753