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Subject:	United States Commodity Funds -- Comments to Position Limits and Definition of Major Swap Participant
Attach:	USCF_ Comments to Position Limits in Dodd-Frank.PDF

On behalf of our client, United States Commodity Funds, LLC, attached please find a comment letter addressing the implementation of position limits and the definition of "major swap participant" under Dodd-Frank.

Regards,
Ann

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October 21, 2010

VIA E-MAIL

Mr. David Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Advance Comments on Position Limits and the Definition of "Major Swap Participant" Under the Dodd-Frank Wall Street Reform and Consumer Protection Act

Dear Mr. Stawick:

We are submitting this letter on behalf of United States Commodity Funds LLC ("USCF"), a commodity pool operator registered with the Commodity Futures Trading Commission (the "CFTC" or the "Commission"), that manages several exchange traded commodity pools, including the United States Oil Fund, LP ("USO") and the United States Natural Gas Fund, LP ("UNG"). USCF previously provided comments to the Commission concerning position limits on certain energy contracts in connection with the CFTC's Notice of Proposed Rulemaking entitled: *Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations* ("Proposed Rule"). The Proposed Rule was recently retracted by the Commission in response to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). Section 737 in Title VII of the Act gave the Commission a broad mandate to impose position limits (the "Dodd-Frank Position Limits") on a much wider scope of products than those covered by the Proposed Rule. USCF believes that its comments on the Proposed Rule remain applicable to the position limits to be imposed by the Commission under the Act. As a result, USCF now resubmits its comments regarding position limits in substantially the same form as previously provided to the Commission. USCF's responses to selected questions posed by the CFTC in the Proposed Rule (which responses were included with USCF's original comments) are attached hereto as Appendix A. USCF would also like to take this opportunity to comment on the definition of "major swap participant" under the Act.

We continue to believe that the ability of USCF (and other firms that manage similar publicly traded, un-levered, passive commodity funds) to prudently meet the investment objectives of the commodity pools that it manages will likely be significantly hampered by the imposition of restrictive limits. We also believe that the significant additional regulatory requirements to which USCF and the Funds would be subject if USCF or any of the Funds are deemed to be "major swap participants" under the Act would similarly hamper the ability of USCF to efficiently meet the Funds' investment objectives. As a result, and more importantly, the value of the exchange traded pools managed by USCF to the hundreds of thousands of investors in our pools, and the several million investors in all similar pools currently in operation in the United States, could be adversely affected by both (1) the adoption of the Dodd-Frank Position Limits and (2) classification of USCF as a major swap participant under the Act.

We note that, other than with respect to restrictive position limits and the potential regulation of firms that manage publicly traded, un-levered, passive commodity funds as major swap participants, we are in favor of and support the Act and its new regulatory regime. We are specifically not opposed to the provisions of the Act that (1) require clearing, (2) limit leverage through margin requirements and (3) create transparency through reporting requirements. We believe that these requirements will improve the integrity and stability of the United States financial markets.

Position Limits. With respect to position limits, our comments below elaborate on our statements above regarding the effect in general that position limits will have on publicly traded, un-levered, passive commodity funds and specifically address the following key points:

- We are of the view that position limits should be imposed on the persons or entities whose investment decisions cause the purchase or sale of a future or swap governed by the limits. In the case of USCF and the Funds, that would be the Funds' individual investors.

- **To the extent position limits are imposed above the individual investor level, position limits should be imposed at the fund level and not the passive advisor level.** USCF and other firms that manage similar publicly traded, un-levered, passive commodity funds do not enter into transactions for their own account but instead invest on behalf of the commodity funds they manage. These passive managers do not assume any of the credit risk associated with the funds' positions and, unlike active fund managers, do not even make any of the investment decisions for the funds they manage. In a colloquy on July 15, 2010, Senator Blanche Lincoln, the Chairperson of the Senate's Agriculture Committee, supported our position when she noted that "it may not be appropriate to aggregate the positions of entities advised by the same advisor where such entities have different and systemically determined investment objectives." It is the individual investors in the passive commodity funds who actually make the buy/sell decisions resulting in the purchase or sale of commodity futures contracts. Accordingly,

we believe that it makes the most sense to impose position limits at the individual investor level but, to the extent the limits are imposed at a higher level, the limits should be at the fund level. Each fund managed by USCF is a separate legal entity with separate investors and separate investment objectives. Aggregating the positions held by these separate funds would not do anything to protect the commodity markets or the overall financial system.

- **Position limits should apply to aggregate positions maintained across different types of transactions.** The CFTC should set aggregate limits for positions maintained in exchange traded futures contracts and clearable trades, as opposed to separate limits for each type of transaction. Otherwise, a derivatives market participant that only maintains positions in one type of transaction would not be able to enter into as many transactions as a derivatives market participant who maintains positions in different types of transactions.

Finally, we also believe that the CFTC should gather more information about the size of the OTC market and the effects of position limits on excessive speculation before setting position limits. At this point, the exact size of the OTC derivatives market is unknown but it is estimated that the aggregate notional amount of OTC derivative transactions outstanding in 2008 and 2009 was $600 trillion.[1] Reporting requirements under the Act will enable the Commission to obtain a better picture of the size and the types of trades outstanding in the OTC derivatives market. In addition, the Act requires the CFTC to consult with designated contract markets to study the effects of position limits on excessive speculation and migration of capital to trading venues abroad.[2] We believe that the Commission's analysis of the market information it will obtain through these reporting requirements and this study is a crucial first step that the Commission must take before it can effectively set any meaningful position limits.

Major Swap Participant. We believe that the Commission should adopt regulations confirming that USCF and other firms that manage similar publicly traded, un-levered, passive commodity funds should not be regulated as "major swap participants." For the same reasons discussed herein with respect to position limits for publicly traded, un-levered, passive commodity funds, the phrase "substantial position" as it is used in the definition of "major swap participant," should be measured at the individual investor level and not at the fund level. Alternatively, the Commission should clarify by regulation that the futures contracts invested in by USCF and other publicly traded, un-levered, passive commodity funds are not the types of transactions that Congress intended to be included in the calculation of whether a person maintains a "substantial position" in swaps and is, as a result, subject to increased regulation as a major swap participant. In addition, with respect to the phrase "substantial counterparty

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[1] See Congressional Record at S.5878 (July 15, 2010).

[2] See §719(a) of the Act.

exposure" as it is used in the second prong of the "major swap participant" definition, the Commission should take into account the fact that USCF's positions are all fully collateralized and USCF therefore does not create counterparty exposure, let alone substantial counterparty exposure. Finally, we believe it is legally incompatible with the intent of the regulations for the passive manager of a family of publicly listed investment funds to be deemed a "major swap participant" because in all cases of which we are aware, the passive manager is not itself a party to any swaps.

I. Description of USCF and its Related Funds

a. Structure

As a registered commodity pool operator, USCF is general partner or sponsor of and manages the United States Oil Fund, LP, the United States Natural Gas Fund, LP, the United States 12 Month Oil Fund, LP, the United States 12 Month Natural Gas Fund, LP, the United States Gasoline Fund, LP, the United States Heating Oil Fund, LP, the United States Short Oil Fund, LP, the United States Brent Oil Fund, LP, and the United States Commodity Index Fund (each, a "Fund" and collectively, the "Funds"). Each of the Funds is an exchange traded commodity pool that principally invests in futures contracts for commodities with the investment objective of having the net asset value ("NAV") of the units of each Fund reflect changes in percentage terms of the price of a given commodity futures contract.[3] The specific commodity focus and investment strategy of each Fund varies; however, the structure and method of investing in all of USCF's Funds are nearly identical.[4] Units of each of the Funds are listed on the NYSE Arca, Inc. ("NYSE Arca"). Publicly listed investment pools such as ours, and those operated by other passive managers, are frequently referred to as "commodity ETFs," although such a description is not technically correct.[5]

Each of the Funds has thousands of investors (for example, USO and UNG had, respectively, over 300,000 and 400,000 investors during the course of 2009)[6] and no investor, to the Funds' knowledge, has ever held more than 5% of the units outstanding of any Fund, other than a handful of occasions typically during the period when a Fund initially offers its units to

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[3] United States Commodity Index Fund is slightly different than the rest of USCF's Funds, in that it uses an index of commodities as its benchmark rather than a single commodity futures contract.

[4] Although it operates in a similar fashion as the other Funds, USCI is structured as a statutory trust rather than a limited partnership, which is the structure used for each of USCF's other Funds.

[5] ETFs are considered to be exchange traded vehicles that are registered with the U.S. Securities Exchange Commission ("SEC") under the Investment Company Act of 1940 ("1940 Act"), while the "commodity ETFs" are generally registered under the Securities Exchange Act of 1934 ("1934 Act").

[6] According to data compiled in connection with providing Internal Revenue Service Schedule K-1 tax forms.

the public and has few investors.[7] Based on discussions with other managers of similar passive commodity funds, we estimate that the total number of individual "retail" investors in the United States who hold investments in such exchange traded commodity funds is between 3,000,000 and 4,000,000 based on 2009 totals.

b. Investment Objective

The objective of the Funds is generally to allow both retail and institutional investors to easily gain exposure to the commodity markets in a cost-effective manner. Commodity prices impact all investors either directly or indirectly and there has been a growing appreciation by investors that it may be appropriate to address the escalation and volatility of commodity prices through participation in the financial markets. Investors have several avenues of participation, including directly buying and selling exchange traded futures contracts. If each of the Funds' investors individually elected to gain exposure to the commodity markets through the purchase and sale of exchange traded commodity futures contracts, the Dodd-Frank Position Limits would be of little consequence because it is extremely doubtful that any Fund investor would ever hold enough futures contracts to be impacted by the Dodd-Frank Position Limits.[8] Thus, it is solely because such investors seek to obtain their financial exposure to the commodity markets collectively in a simpler, unleveraged and economically efficient manner through the Funds that they will likely suffer adverse effects from adoption of the Dodd-Frank Position Limits.

The Funds have directly made the case to the Commission that the Funds' collective investments in futures contracts have not in fact contributed to either the volatility or run ups (or run downs) in energy prices experienced over the last several years.[9] Perhaps this explains why in its Proposed Rule the Commission repeatedly made the point that it was not required to base its position limits on a finding that the positions of a certain size constitute excessive speculation that create an actual burden on interstate commerce.[10] Rather, the Commission stated that it "may make and promulgate such rules and regulations that in its judgment are reasonably necessary to accomplish any of the purposes of the [Commodity Exchange Act]."[11] Any

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[7] Since each of the Funds are registered under the 1934 Act, investors holding 5% or more of a Fund's units are required to disclose their holdings and intentions under Section 13 of the 1934 Act.

[8] Although it is theoretically possible that the positions of a single investor in one of the Funds could breach the limits set out in the Proposed Rule, this has not occurred to date and we believe mechanisms could be put in place that would assure that any investor in the Funds whose positions could breach the limits would be identified.

[9] *See* USCF Comment Letter to the CFTC's Concept Release on Whether to Eliminate the Bona Fide Hedge Exemption for Certain Swap Dealers and Create a New Limited Risk Management Exemption From Speculative Position Limits, 74 FR 12282 (March 24, 2009), filed June 16, 2009; Testimony of John Hyland, Chief Investment Officer of USCF, before the CFTC on August 5, 2009.

[10] *See, e.g.*, Proposed Rule, 75 FR 4144, at 4148 (January 26, 2010).

[11] *Id.*

questions that may have existed regarding the legal authority asserted by the Commission for the Proposed Rule have been made moot by the Act. However, we still believe the Commission cannot escape the question of whether it is wise or appropriate for it to adopt rules that will interfere with the ability of ordinary citizens to gain exposure to our energy markets in a cost effective and efficient manner. The mere fact the Commission must adopt position limits pursuant to the Act does not mean that such action should be taken in an overly restrictive fashion.

II. Comments on Position Limits

a. Rationales for Position Limits

We believe that there are essentially four reasons why position limits might be justifiably imposed on market participants (outside of the limits traditionally put in place during the final days before expiration of futures contracts when delivery becomes an issue). However, none of these reasons appears to provide a viable rationale for imposing position limits on publicly traded, non-leveraged, passive commodity investment funds.

Settlement Risk. The first reason for imposing position limits on market participants is to avoid a situation in which an unusually large owner of futures contracts becomes a settlement risk to the futures contracts' exchange clearing house. This could occur if a large entity took a position, long or short, that went against it in such a fashion that it was unable to post additional margin to cover such position, or the entity in fact went bankrupt. This scenario in turn could force the entity's futures commission merchant ("FCM") to have to make good on the open positions of the failed entity. It is possible that this scenario could precipitate the failure of the FCM, which in turn would place the cost of the open positions onto the clearing house and its members. The level of settlement risk presented in this scenario, however, is different depending on the type of entity holding large positions.

As an example, let us assume there are four types of potential very large holders of futures contracts. Our entities for this example are the following:

1) *A hedge fund or other purely financial investment firm.* Such a firm would often use very large amounts of leverage (10 times or more), take a meaningful price risk in its investments in futures contracts, and have a highly liquid, but small, capital base.
2) *A large bank or investment bank that acts as a dealer in both futures and commodity related swaps.* Such an entity would also be highly levered (10 times or more), would not always be taking a price risk with its positions in futures contracts since it would sometimes be acting as an intermediary, and would have a relatively large capital base that would be a mixture of liquid and illiquid holdings.

3) *A large commodity end-user, producer, or dealer in the physical commodity.* Such a firm would typically, but not always, be hedging its price exposure, would have lower levels of leverage, and might have a large but very illiquid capital base.
4) *An exchange traded commodity fund ("commodity ETF").* Such a fund would typically be un-levered, would not itself be taking any price risk since it is a passive index-like vehicle (although its individual investors would be taking price risk), and would have a very large and very liquid capital base.

In the above examples, the biggest candidate for settlement risk is #1, the hedge fund, and the lowest risk is #4, the commodity ETF. However, the position limits in the Proposed Rule would have essentially put both the highest and lowest risk participants (#1 and #4, respectively) in the same and most restrictive category in terms of limits on holdings. However, the Proposed Rule would have allowed the second riskiest category, the dealer (entity #2), to hold twice as many futures contracts as the least risky category (entity #4) under that proposal. Finally, the third riskiest category, the commodity end-user (entity #3), would have been essentially allowed unlimited holdings.[12]

Market Manipulation. The second rationale for the limits is to prevent illegal manipulation in the markets by a large holder of contracts, *i.e.*, to prevent some sort of "corner" of the market or other manipulative operation. As major investors on behalf of hundreds of thousands of shareholders in USCF's commodity ETFs we are certainly in favor of protecting the markets we invest in against such manipulation. However, we fail to see how such a concern is properly addressed by placing position limits on publicly traded, passive, un-levered funds such as ours.

The history of the commodity markets suggests that three elements are usually present when a person or firm sets out to deliberately manipulate the market. First, they need secrecy, given that if everybody knows what they are doing they will not succeed. Second, they need leverage, since in any large commodity market an entity's ability to influence prices with certainty will usually be limited to small amounts and for short periods of time. Finally, they almost certainly need to be able to participate in BOTH the futures market and the physical market, because we believe solely using futures contracts does not provide these bad actors with an adequate tool to create the artificial price necessary to implement their plan.

Based on these three identified elements, and using the same four potential categories of very large holders that we postulated above, we believe that the category that has the greatest

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[12] We believe that the common argument that commodity end-users and producers represent the lowest risk category is refuted by the numerous problems caused in the financial commodity markets by these types of entities, including: Sumitomo Corporation, Metallgesellschaft Corporation, China Aviation Oil, the Hunt brothers, and the Chinese State Reserve Bureau, all of whom were physical players in commodities as well as users of futures contracts).

potential for manipulative abuse is category #3, a large physical player who also uses futures.[13] The second most likely candidate is #2, the bank or investment bank, with #1, the hedge fund, a distant third.[14] The least likely candidate is #4, the commodity ETF, since they are typically too transparent, too un-levered, and too tied to their benchmark or index to be a remotely plausible candidate.

Reduction of Volatility. The third rationale is that the Commission desires to reduce the average amount of price volatility in various commodity markets. Technically we understand that the Commission refers to this as taking action to "...diminish, eliminate or prevent excessive speculation...." However, it is unclear what the phrase "excessive speculation" really means in this context. We have not seen a precise definition of what excessive speculation really is or how the Commission measures it. For the purposes of this comment letter we will view the purpose as an attempt to reduce the average amount of price volatility of a particular commodity over some period of time. That still leaves the issue of how to determine what is the normal or "correct" level of price volatility, a problem that we will not attempt to resolve in this letter.

The concern we have with imposing position limits on publicly listed, passive, un-levered commodity funds is that the empirical evidence suggests that in doing so the Commission will not obtain a reduction in price volatility. In fact, the Commission is more likely to create in increase in price volatility. The recent price movements in crude oil between 2007 to 2010, for example, the reports of the CFTC's own staff,[15] the studies done by recognized energy market academics,[16] and the data published by firms such as ours,[17] all make clear that financial investors in general, and commodity ETFs in particular, tended to be net sellers of crude oil futures contracts during the mid-2007 to mid-2008 run up in oil prices, were net buyers of contracts during the fall in oil prices between mid-2008 and early 2009, and have once again been net sellers in the more recent rise in crude oil prices between early 2009 and early 2010. If the Commission presumes that large scale buying and selling of futures contracts can directly influence the price of the spot commodity, which is itself a highly debated point, then the only conclusion that can be drawn is that the actions of

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[13] As previously noted, we believe that the common argument that commodity end-users and producers represent the lowest risk category is refuted by the numerous problems caused in the financial commodity markets by these types of entities, including: Sumitomo Corporation, Metallgesellschaft Corporation, China Aviation Oil, the Hunt brothers, and the Chinese State Reserve Bureau, all of whom were physical players in commodities as well as users of futures contracts).

[14] In the example given, the hedge fund is not a large risk to manipulate a commodity market because it is generally not long or short physical supply and thus it is unlikely to be able to influence spot prices or, on a risk free basis, move the futures curve. The same line of argument applies to USCF's Funds and other commodity ETFs that operate in a similar fashion.

[15] *See, e.g.*, Interagency Task Force on Commodity Markets (July 2008) ("Interagency Commodity Markets Study") and CFTC Trader Activity and Derivative Pricing (December 4, 2008) ("CFTC Pricing Study").

[16] *See, e.g.*, Philip K. Verleger, Jr., Stephen Craig Pirrong, Dwight R. Sanders and Scott H. Irwin, among others.

[17] *See infra* pp. 17-20 and accompanying notes.

commodity ETFs over the last three years have been to moderate volatility in crude oil prices, not increase it.

By comparison, many of the claims made by proponents of position limits in general, and position limits on passive, non-levered investors in particular, lack any serious analysis or justification. Typically the "data" that supports these claims consists of saying that on a particular date a fund did "A", and the markers or prices did "X", thus "proving" that the fund's action caused the described outcome. However, all the claims we have seen appear to have engaged in selective data cherry picking. They don't seem to mention that perhaps a month earlier than the above example the fund also did "A", but the market or prices did "Y", not "X." Or that a week after the fund did "A" the market or prices did "X" while the fund took no actions at all. Other common claims are rooted in this logical fallacy of confusing correlation with causality ("*cum hoc ergo propter hoc*"). A common claim of this sort is "Commodity prices rose over the last 5 years while passive investments rose over the last 5 years. Ergo, passive investments caused commodity prices to rise." Leaving aside the statistical issue of "auto-correlation" in the example just cited, the CFTC's own staff rejected this claim in several of its reports as have studies by the commodity futures exchanges and many notable economists.[18]

The foregoing is not to suggest that other types of major market participants have a similar effect on commodity prices. The data we have seen and cited refers to the impact on markets of publicly traded, passive, and un-levered commodity funds. We cannot comment on the usefulness of position limits on other types of market participants in regards to attempting to lower price volatility. However, we would note that the United Kingdom's financial markets regulator, the Financial Services Authority ("FSA"), recently cast serious doubts on the usefulness of position limits to moderate price volatility. In its white paper dated December 2009 and titled "Reforming OTC Derivatives Markets – A UK perspective" ("FSA White Paper"), the FSA stated the following:

> *In any event, we do not believe a case has been made which demonstrates that prices of commodities, or other financial derivatives, can be effectively controlled through the mandatory operation of regulatory tools such as position limits, whether on exchange or OTC. Analysis of market data where position limits are already in use suggests that this has not shown a reduction in volatility or absolute price movements compared to contracts where they are not.*[19]

We are unaware of any evidence or studies that would lead us to contradict the FSA's conclusion.

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[18] *See supra* notes 13-14.

[19] FSA White Paper, at chapter 9.

Price Setting. The fourth and final rationale is to set prices at some level that the Commission determines is desirable. However, the Commission and the individual Commissioners have made clear that they do not view their roll as that of a "price setting" agency. In addition, if you accept the conclusion of the FSA cited above, it appears that even an attempt to be a price setting body is destined to fail.

For example, the managers of USCF believe that the prices of crude oil is determined primarily by the interplay of supply, demand, available inventory, the value of the U.S. dollar (the currency crude oil is priced in), and amount of spare production capacity that exists at any point in time. The CFTC's own studies, including the Interagency Commodity Markets Study and the CFTC Pricing Study, make clear that these fundamentals, not speculation, drove prices during the 2008 run-up in commodity prices, including not only crude oil and other commodities for which listed futures contracts exist but also for commodities for which no futures market exists.

In particular, we would encourage observers to study Figure 10 on page 56 of the CFTC Pricing Study. It makes very clear that at all times during 2007 and 2008 when oil prices were high that spare oil production capacity was essentially zero (the chart actually measures all spare capacity except for Saudi Arabia, however, published reports in early and mid 2008 suggest that essentially Saudi Arabia had little or no spare capacity at that time for light, sweet crude oil).[20] Our own belief is that, regardless of CFTC or FSA actions, market fundamentals will determine prices. Should global crude oil spare capacity again approach zero in the near future we can foresee that oil prices will in fact once again rise to record levels. We do not foresee position limits having any meaningful impact on that possibility.

b. Aggregation Issues with respect to "Person"

1. "Look-Through" and Passive Investment Funds

Even if the Commission believes that position limits on commodity futures contracts would have a positive effect on the financial energy markets, we question why the position limits in the Commission's Proposed Rule did not provide for a "look-through" to the actual investors in entities such as the Funds, and hope that the Commission will reconsider this issue when implementing the Dodd-Frank Position Limits. This would be a more rational approach because it is the Funds' investors and not the Funds themselves that are in fact making the buy/sell decisions resulting in the purchase or sale of commodity futures contracts. In this context, the Funds are "aggregators but not actors" from an investment standpoint. Placing limits on the futures contract positions owned by passive entities like the Funds will not curtail investor interest in the financial commodity markets. To the contrary, all available evidence points to

[20] *See* International Energy Agency Monthly Oil Report (May 13, 2008).

growing investor interest in gaining exposure to these markets because such investment provides a prudent means of balancing an investor portfolio. As a result, limiting the Funds' ability to meet investor demand for exposure to financial commodity markets may force investors into less transparent mechanisms for hedging their commodity-related and other investment risks.

As noted above, to our knowledge all publicly traded, passive, and un-levered energy commodity funds are registered under the 1934 Act. As such, any investor with large holdings of shares or units, in excess of 5% of a particular fund's outstanding shares, is required to notify the SEC, through a public filing, of its ownership interest in the fund.[21] Thus it would be very easy for the CFTC to monitor individuals or firms that invest indirectly through the funds into the commodity markets at very large levels. However, we would observe that we have rarely seen any such filings for any of our large funds. In the case of USO for example, it has been almost four years since any investor filed a Form 13G indicating that it owned 5% or more of USO. At that time, USO was in fact quite small (assets of $10 million). As was pointed out during testimony on behalf of USCF in the August 2009 CFTC hearings on these topics, we believe that investors interested in taking very large positions in the commodity markets would typically not elect to use what is essentially a retail product. To be blunt, they are not willing to "pay retail" in terms of the cost of using a fund such as ours versus directly buying futures contracts or over-the-counter ("OTC") swaps.

If the CFTC wished to be able to see investors who hold sizable amounts of indirect exposure to the commodity futures markets via exchange traded funds, but were still under the 5% limits, we believe that could be accomplished relatively easily with minimal costs to investors, exchanges, broker-dealers, or fund operators. The broker-dealers who buy and sell shares of exchange traded commodity funds for clients are already required to report the names and holdings of clients at the end of each year to those commodity funds that elect limited partnership tax treatment so that the funds may send out tax reporting statements (many, if not all, exchange traded commodity funds are partnerships for tax purposes). Thus, the mechanism is already in place for surveillance on a once a year basis. If the CFTC wished to have more frequent reporting of ownership information, we believe that likely would entail a discussion between the CFTC and the SEC. However, given the SEC's current reporting regime and the proposal for large trader reporting noted above, such additional reporting is reasonably possible. Although broker-dealers are typically only required to submit the holdings data of their clients to the funds for tax reporting purposes after the close of the calendar year, in fact the major broker-dealers report the data pretty much on a monthly basis already. As a result we think that creating

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[21] *See* 1934 Act Rule 13-a1. In addition, we note that institutional investment managers having investment discretion over accounts with securities valued at $100,000,000 are required to report each calendar quarter their equity holdings in such publicly traded funds. *See* 1934 Act Rule 13f-1. Finally, we note that the SEC recently proposed a rule to require certain large traders to report aggregate trades above certain trading levels established by the SEC. *See* SEC Release No. 34-619086 (April 14, 2010).

a workable "look-through" system in real time would be doable using existing systems in place at the broker-dealers.

2. Passive Investment Managers

We would further comment on the notion of aggregation when discussing position limits and publicly listed, passive and un-levered commodity funds such as the Funds. When calculating position limits, to the extent separate, publicly listed funds with separate investors happen to maintain positions in the same commodities, we do not think that any actual regulatory benefit will come from aggregating the holdings of such funds merely because they have the same passive manager. The material point here is that the funds are distinct legal entities and designed to track different benchmarks or investment objectives and, accordingly, the passive manager of each fund is not making any investment decisions.

We believe our view is logical because the case of a passive investment manager running two or more funds with separate investors and separate investment objectives is not comparable to an active manager with investment discretion running two or more funds. Unlike in the case of an active manager, USCF and other passive managers do not have any discretion with respect to the commodities positions held by each fund they manage. Alternatively, the commodity positions of these funds are determined based on an established methodology for each fund and the buy/sell decisions of each fund's investors. Aggregating position limits across the passive funds managed by the same passive manager could actually have a negative impact on the financial system to the extent that it causes the manager to have to move investments to unregulated and/or foreign markets.

As an example, assume that there are two separate listed commodity funds that both own futures contracts in commodity X. Both funds have different shareholders, different investment objectives or index benchmarks, and buy and sell independent of each other. However, in this example we will state they have the same passive manager whose job it is to run the funds according to their differing investment objectives. So the passive manager is not in the same situation as a hedge fund manager who runs two different hedge funds. The passive manager is "an aggregator, but not an actor." As stated before, for investment decision making purposes the "actors" are the thousands or hundred of thousands of investors.

Further assume that each of this passive manager's commodity funds owns 60% of the appropriate position limit. If we had a situation where the CFTC indicated, due to aggregation, that the two funds could no longer own the number of contracts they have, this would create a number of potential negative outcomes for the shareholders that could lead to higher cost, greater risks, or less desirable tracking of the investment objective or benchmark.

Alternatively in this scenario, the passive sponsor could just sell the management of the second fund to a passive competitor who has no exposure to commodity X. In that situation we would have the exact same shareholders invested in the exact same passive benchmark or index and owning the exact same number of contracts as before. The buying and selling of futures contracts for the funds would be completely unchanged. All that would have happened is that the first passive sponsor was forced into a sale of a part of its business to a second passive manager for non-economic reasons. But it is not clear how this benefits the market in general, or the regulators in particular, even if it is presumed that position limits are desirable. The "actors" and the holdings are unchanged.

It is our belief that any aggregation of position limits as applied to passive investment pools needs to differentiate between two funds that have different shareholders and different investment objectives as compared with two funds that are merely identical clones of each other and were created solely to avoid position limits. In the first case we do not think aggregation is appropriate since it appears not to serve any useful regulatory purpose (except making the second passive sponsor happy). In the second example we think aggregation does make sense.

Legislators drafting the Act recognized the need to consider the attributes of public, exchange traded funds like the Funds when determinating the application of the Act's regulatory requirements. In a colloquy on July 15, 2010, Senator Blanche Lincoln, the Chairperson of the Senate's Agriculture Committee, indicated that transactions entered into by un-levered, exchanged traded funds whose positions are fully collateralized should be treated differently from highly leveraged swap transactions that pose systemic risk and may distort price discovery.[22] In the same colloquy, Senator Lincoln went on to say that "it may not be appropriate to aggregate the positions of entities advised by the same advisor where such entities have different and systemically determined investment objectives."[23] The foregoing statements support the argument that the Funds, and other similar un-levered, exchange traded, passive funds, warrant separate treatment under the rules ultimately promulgated by the Commission. The following language would accomplish this goal:

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[22] Congressional Record-Senate at S5919 (July 15, 2010) ("However, I still hold some reservations about these financial market participants and the negative impact of excessive speculation or long only positions on the commodities markets. While I have concerns about the role these participants play in the markets, I do believe that important distinctions in setting position limits on these participants are warranted. In implementing Section 737, I would encourage the CFTC to give due consideration to trading activity that is unleveraged or fully collateralized, solely exchange-traded, fully transparent, clearinghouse guaranteed, and poses no systemic risk to the clearing system. This type of trading activity is distinguishable from highly leveraged swaps trading, which not only poses systemic risk absent the proper safeguards that an exchange traded, cleared system provides, but also may distort price discovery.")

[23] *Id.*

Positions taken under trading programs of un-levered, passive, exchange traded commodity funds that (1) have separate ownership and separate investment objectives, (2) fully disclose their futures and other derivatives positions and (3) invest in futures contracts and other derivatives on a systemic basis in furtherance of these separate investment objectives and the decisions made by unaffiliated investors, should not be aggregated.

c. Aggregate Position Limits Across Different Types of Transactions

We believe that position limits should apply to aggregate positions maintained across different types of transactions. A clear objective of the Act is to move as much derivative trading as possible to regulated futures markets and derivative exchanges, not to unnecessarily distinguish between trades on futures exchanges and trades cleared through derivative clearinghouses. If separate limits are set for exchange traded futures contracts and clearable[24] trades, then derivatives market participants who only engage in certain types of transactions (i.e., exchange traded futures contracts) will be unnecessarily penalized by being subject to lower overall limits than derivatives market participants who engage in transactions in both categories. For example, if an entity has 100 positions in exchange traded futures contracts for a specific commodity, but the limits for such commodity are set at 50 positions in exchange traded futures contracts and 50 positions in clearable trades, the entity would most likely move half of its trading with respect to such commodity off the futures exchanges to the similarly-regulated derivative clearinghouses. We do not believe this migration away from the futures exchanges is consistent with the Act's purpose of protecting the United States financial markets because derivative clearinghouses should not be any more or less risky than futures exchanges.

As further support for the foregoing arguments that position limits should be set based on aggregate position in a particular commodity, we are unaware of any regulatory basis for not treating a listed futures contract and a clearable swap on the same commodity as economically equivalent. Market participants should therefore be able to choose between the use of listed futures or clearable swaps, based on their own determination of suitability or most favorable execution.

If the Commission does not set aggregate position limits as discussed above, then the Commission should at least provide derivatives markets participants some flexibility in complying with limits across the different types of transactions. The rationales for position limits discussed at the beginning of this letter principally apply with respect to exchange traded

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[24] We refer to "clearable" trades as opposed to "cleared" trades because under the Act, to the extent a trade is clearable, such trade must be cleared unless it qualifies for an exemption to the clearing requirements. If a trade is not cleared because Congress and/or the Commission have determined that it does not need to be cleared (i.e., because it is a trade entered into by an end-user to hedge or mitigate commercial risk) then for purposes of complying with position limits, such trade should be treated the same as similar trades that are actually cleared.

futures contracts. Accordingly, if the Commission determines that separate limits are necessary for these exchange traded futures contracts, then these separate limits should be a sublimits of the aggregate positions that may be maintained by a derivatives market participant across all types of transactions with respect to a specific commodity. For example, if the Commission sets the limit for exchange traded futures contracts for a specific commodity at 50 positions, then instead of also setting a limit of 50 positions for clearable trades, the Commission should set an overall limit of 100 positions, 50 of which may be with respect to exchange traded futures contracts. By way of example, under this overall limit of 100 positions, a derivatives market participant could have 50 positions in clearable trades and 50 positions in exchange traded futures contracts, 75 positions in clearable trades and 25 positions in exchange traded futures contracts, or 100 positions in clearable trades and 0 positions in exchange traded futures contracts, and so on, so long as such entity never maintained more than 100 positions in the aggregate or more than 50 positions in exchange traded futures contracts.

d. "Reasonably Necessary" and Cost to the System

As indicated above, we question the desirability of imposing position limits on previously regulated entities that are publicly listed, highly transparent, passive, un-levered commodity funds. We believe there are serious questions about the actual benefit that will be derived by such an approach. As such we do not see the basis on which the Commission could conclude that such actions "...in its judgment are reasonably necessary...."

An observer might want to conclude that position limits are desirable because even if there is only a one in a thousand chance that passive, un-levered funds might pose a threat to the system then the additional regulation would be worthwhile. However, if that low of a threshold is the basis of the Commission's judgment we must point out that to be consistent the Commission would have to impose position limits on every market participant, including physical participants, since the other categories of market participants all present greater risks than passive, un-levered funds. In fact, the United Kingdom's Financial Services Authority (the "FSA") specifically commented on this topic in the FSA White Paper, stating that the FSA did not believe that position limits should be imposed on one class of market participants but not imposed on other groups:

> *In relation to controlling or limiting price movement, we have seen no evidence to suggest that one particular type of market participant has been solely responsible for systematically driving derivative market prices. As a result, we do not believe that limiting one class of market participant by imposing specific limits is a desirable or warranted response to the changing nature of derivative markets.*[25]

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[25] FSA White Paper, at chapter 9.

At the same time, we believe there will be definite harm to the market and market participants if restrictive rules are imposed. Should limits similar to those in the Proposed Rule be adopted, investors seeking access to these markets may choose any number of ways in which to avoid or circumvent the Commission's proposed position limits, including those discussed below. We believe that the harm to the financial commodity market and the related market participants resulting investor actions to avoid position limits can come in the following three ways:

First, existing funds could themselves go to foreign markets to satisfy investor demand.[26] Additionally, they may modify their investment objectives or benchmarks to avoid exceeding position limits. In any of these cases, investors will find themselves facing additional costs and risks. We believe the most prudent and efficient way for commodity ETFs to provide investors with access to the financial commodity markets and to fulfill the funds' investment objectives is to buy and sell exchange traded commodity futures contracts in the U.S. futures markets.

To the extent that a commodity ETF makes use of non-U.S. futures contracts and futures exchanges, then the investors in such entity may face not only greater cost but also certain settlement, clearing, and currency risks that might be avoided by the use of listed U.S. futures contracts. Finally, to the extent that a commodity ETF changes its investment objective to accommodate these proposed regulations, it may be the case that investors are denied the opportunity to invest in what they actually want, versus what regulators will permit them to have.

Second, new funds can be created by new sponsors to tap investor demand that cannot be satisfied by the existing funds that may find themselves "limited out." In either case, the impact, if any, on participation in the commodity futures markets will likely be the same as if the Dodd-Frank Position Limits were set at reasonably high levels or modified to provide a "look-through" to the existing funds' actual investors. As was stated before, exchange traded passive commodity funds are "aggregators, not actors." The actual actors, the hundreds of thousands of investors, will find another way to achieve their goals. It is indeed ironic that at a time when the Commission and other financial regulators are pressing to move trading from the OTC markets to the regulated futures markets in order to promote transparency and reduce systemic risk, the Commission would itself pursue a new regulation that will encourage migration of trading away from the regulated futures markets to the OTC and foreign markets.

However, the outcome of a situation where the commodity ETF market goes <u>from</u> a model of one large, highly liquid commodity ETF in a particular segment along side several

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[26] Even though the Dodd-Frank Position Limits will aggregate U.S. futures contract positions with OTC contracts performing a significant price discovery function and linked contracts on foreign exchanges, market participants may be forced to use OTC and foreign contracts if restrictive limits are placed on U.S. futures contracts in order to utilize the full scope of any aggregate limits.

smaller, less liquid commodity ETFs, to a model that instead has several medium sized commodity ETFs will certainly entail additional costs to be borne both by the investors and by the commodity market itself. Empirical evidence shows that total liquidity for investors will drop and the cost of buying and selling their investments will go up. We believe this in turn will lead to an overall drop in liquidity seen on listed futures exchanges such as the New York Mercantile Exchange ("NYMEX") and the ICE Futures ("ICE").

To see how this might come about, we have included the following examples from the existing ETF markets that demonstrate how we reached our conclusions.[27]

One of the largest equity ETFs in the world is the SPDR (ticker: SPY), which tracks the S&P 500. It has $73 billion in assets and trades approximately 200 million shares a day. Due to its size and volume, shares of SPY trade during the day at an average spread of 1 cent. However, there is another S&P 500 based ETF in the marketplace, the iShares S&P 500 Index Fund (ticker: IVV). IVV has $22 billion in assets at the present time, an amount equal to 28% of SPY's assets. However, IVV only trades 4 million shares a day, an amount equal to only 2% of SPY's volume. IVV also typically trades at a wider bid/ask spread during the market day of 2 cents. We would suggest that if for some reason regulatory action forced SPY to get smaller than the other existing S&P 500 ETFs would become larger, and new S&P 500 ETFs would likely spring up, as investors moved into ETFs that could still accommodate their investments. However, we also believe that in that situation, the spread on these medium-sized ETFs would be higher than the current 1 cent spread of SPY. Assuming that the actual amount of shares trading remained constant, an extra 1 cent in spread would cost investors an extra $500 million a year in trading cost to achieve the same exposure they currently obtain from the very large SPY. That cost to investors would come with no apparent offsetting benefit to either the investors or the equity market in general.

At the opposite spectrum from the highly liquid SPY we can view the situation in trading in European ETFs. The counterpart of the S&P 500 in Europe is the STOXX 50. Although the total market cap of the STOXX 50 is less than that of the S&P 500, the average market cap of its 50 holdings is 3 times that of the average of the S&P 500. Thus one could expect that the cost of trading an ETF based on the STOXX 50 should be comparable to trading an ETF based on the S&P 500. However, due primarily to regulatory burdens in place, Europe does not have the same market structure of one very large and liquid STOXX 50 ETF along side several small STOXX 50 ETFs. Instead, Europe has 4-5 medium sized STOXX 50 ETFs and 6-8 small STOXX 50 ETFs. The result is that investors buying or selling STOXX ETFs face bid/ask spreads that are 6-8 cents wide, compared to the 1 cent bid/ask spread of SPY. Once again, multiplied over millions

[27] Data for the following examples was derived from information publicly available on Bloomberg and NYSE Euronext.

of shares traded daily the cost of regulatory balkanization amounts to hundreds of million Euros per year without any offsetting benefit to the investors or the markets themselves.

Finally, in the U.S. energy commodity ETF market, we also have examples of the impact of size and liquidity on investor costs. Our fund, USO, is the largest crude oil commodity ETF in the U.S. It has, at present, assets of approximately $1.7 billion and trades an average of 11 million shares a day at a spread of 1 cent. There are in fact three other crude oil vehicles that have reasonable size, although all are much smaller than USO. These other vehicles include PowerShares DB Oil Fund (ticker, "DBO"), USL, and iPath S&P GSCI Crude Oil Total Return Index (ticker, "OIL").

DBO has assets of approximately $550 million and trades around 340,000 shares a day at a spread of 2-3 cents. USL has assets of approximately $160 million and trades around 40,000 shares a day at a spread of 5-6 cents. OIL has assets of approximately $630 million and trades around 560,000 shares a day at a spread of 2-3 cents.

It is true that in the case of DBO and USL, there are differences in their investment objectives and holdings compared to USO that may contribute to their lower volume and higher bid/ask spreads. However, OIL's investment objective is virtually the same as USO's. Although it has assets that are 32% of USO's, it trading volume is only 7% of USO's. Thus we believe that there is a scale effect where liquidity increases as funds grow larger, and it decreases as funds get smaller.

Looking at the three examples above we think a reasonable observer would conclude that artificially restricting the size of exchange traded passive commodity pools could not only lead to a situation where the market will move from a dynamic of one large liquid player and several small players to a structure of several medium sized players, but that such a transition would be accompanied by a drop in aggregate liquidity and an increase in investors' costs. Using just USO and UNG as examples, if those assets were redeployed into other exchange traded commodity vehicles such that we had several medium sized vehicles, and those vehicles traded at 3 cents instead of the current 1 cent bid/ask of the two large funds, the annual extra cost borne by these same investors would be $20 million. For this increase in cost there is no apparent benefit to investors or the market.

However, as indicated above we think it likely that total aggregate volume of all the medium sized funds is likely to decline compared to the current market structure (remember that OIL only trades 7% of USO's volume although it has 32% of USO's asset size). As such we believe that the overall reduction in combined trading in these vehicles will in turn lead to a reduction in the use of listed commodity futures by equity market makers. Equity market makers hedge their market making in commodity funds by buying/selling listed futures contracts. Assuming a 20%-30% drop in aggregate trading volume of crude oil ETFs under the "many

medium sized ETFs, no big ETF" scenario, would almost certainly lead to a commensurate drop in the use of crude oil futures contracts by equity market makers. Thus there is likely to be a very real and not unnoticeable drop in liquidity in the crude oil futures market if the limits in the Proposed Rule are adopted for the Dodd-Frank Position Limits. We are not able to estimate how much impact this will have on futures markets. However, we would encourage the Commissioners to discuss this scenario with the appropriate individuals at the listed futures exchanges.

There is currently no reason to believe that adoption of the Dodd-Frank Position Limits will diminish the role of the Funds' investors in the regulated futures markets. If the Dodd-Frank Position Limits can be legally circumvented either by moving a portion of the business to the OTC markets (where dealers will in turn hedge their risk by buying and selling futures contracts), by encouraging the formation of new fund entities,[28] or by direct participation in the futures markets by Fund investors, then there is simply no reason to believe that any possible harm currently posed by such investors to the regulated energy futures markets will be eliminated or even reduced. If there are sound economic reasons why the Funds' investors are currently electing to participate in these markets, they will continue to do so even if the new position limits are adopted (albeit at perhaps greater cost and risk).

If the Commission is not attempting to regulate the total amount of futures contracts held in aggregate by smaller investors or "speculators" (and based on comments by individual Commissioners we believe that is true), then to a degree we think the Commission's concerns about the particular size of any individual pass-through fund is somewhat misguided. It is a bit like baseball legend Yogi Berra's response when asked after he ordered a pizza if we wanted it cut into six slices. He is alleged to have answered, "Better cut it into four pieces, I am not hungry enough to eat six pieces." We all understand that if you are going to eat the entire pizza, it does not matter how many slices it is cut into by the person at the counter. Similarly, if individual investors are going to own 10%, 20%, or 30% percent of a particular commodity futures contract, it is not clear to us the actual regulatory benefit that is derived by limiting individual investors' choices when selecting the passive pass-through vehicle by which to achieve this level of exposure, although we can clearly see the extra costs to the investors and the marketplace.

e. Winners and Losers

In recent articles and papers published by noted energy market economist, Prof. Phillip Verleger, he has postulated that the real beneficiary of the proposed position limits will be the

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[28] To the extent that adoption of the proposed rules encourages new entrants into the market, there will likely be duplication of costs. Although we do not seek protection of the Funds from future competition, we believe competition should be based on services provided to investors, not simply circumvention of arbitrary regulatory position limits.

Organization of Petroleum Exporting Countries ("OPEC"), not American end-users or investors.[29] However, based on our discussions with other market participants we would offer up another prime beneficiary: foreign exchanges. Although we would only reluctantly move away from primarily using listed futures on American exchanges, we are aware that many other major commodity market participants have no such reservations.

Although we understand that in implementing the Act's new regulatory regime, the CFTC will seek to adopt rules and regulations with counterparts in foreign markets, it is unlikely that the CFTC will find any such counterparts with respect to position limits. Based on the comments by the FSA in the FSA White Paper, we can only surmise that the FSA will not be joining the U.S. on the issue of position limits. Additionally, given recent studies by the Organization for Economic Cooperation and Development concluding that the "use of financial instruments such as index/swap funds, though important in size, do not impact market returns in most markets and indeed the larger long positions of these funds lead to lower market volatility,"[30] we expect that foreign markets will not see the need to impose restrictive position limits. We therefore think that places like the U.K., Singapore, and China will look forward to taking over the U.S. capital markets dominance in energy and commodity trading like they did in EuroDollars and EuroBonds in the 1970's when the U.S. instituted trading restrictions on banks.

At the same time, should restrictive limits be adopted for the Dodd-Frank Position Limits, the losers will be the millions of investors in commodity ETFs who will face higher costs and risks, the U.S. futures exchanges who will face reduced volume, the commodity market in general which will see greater volatility, and the end-users who ultimately will pay more to the OPECs of the world.

III. Comments on the Definition of Major Swap Participant

We would also like to take this opportunity to comment on the concept and definition of "major swap participants" under the Act. A derivatives market participant will be subject to regulation as a "major swap participant" if it falls within one or more of the following three categories: (1) persons who maintain a substantial position in swaps for any of the major swap categories excluding, *inter alia*, positions held for hedging or mitigating commercial risk; (2) persons whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial

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[29] *See, e.g.*, Philip K. Verleger, Jr., *Comments on Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg. 4144 (Jan. 26, 2010).*

[30] Irwin, S.H. and D.R. Sanders (2010), "The Impact of Index and Swap Funds on Commodity Futures Markets: Preliminary Results", *OECD Food, Agriculture and Fisheries Working Papers*, No. 27, OECD Publishing; Working Party on Agricultural Policies and Markets, Speculation and Financial Fund Activity: Draft Report Annex I (17-20 March 2010).

markets; or (3) financial entities that (a) are highly leveraged relative to the amount of capital they hold who are not subject to capital requirements established by an appropriate Federal banking agency and (b) maintain a substantial position in outstanding swaps in any major swap category.

The Funds should not fall within the second two prongs of this definition because, as discussed throughout this comment letter, the futures contracts in which the Funds invest do not create counterparty exposure and the Funds are not highly leveraged. This leaves the first prong of the major swap participant definition which we believe also should not apply to the Funds or USCF as the investment manager for the Funds.

a. "Look-Through"

Although the swap positions held by the Funds may appear to be large in relation to each Fund as the legal holder of such positions, these investments represent the aggregation of demand from tens of thousands of individual investors seeking to reduce their financial risk through hedging in the commodity futures market. We believe that for the reasons stated above with respect to position limits, the Commission should "look through" the Funds to the individual investors when determining whether a "substantial position" is maintained. The Commission should then exclude the positions maintained by these investors as "positions held for hedging or mitigating commercial risk." By taking these steps, the Funds, and USCF as the investment manager for the Funds, will certainly not be deemed to maintain a "substantial position" in swaps and as a result will not be regulated as "major swap participants."

To the extent the Commission does not look through to the individual investor level, the Commission should at least look through to the individual Funds. As discussed above with respect to position limits, USCF and similar passive investment managers do not enter into trades for their own account and do not assume any (let alone a "substantial" amount) of the credit risk associated with the positions maintained by the funds they manage. We believe that it is legally incompatible with the intent of the regulations for the passive manager of a family of publicly listed investment funds to be deemed a "major swap participant" because in all cases of which we are aware, such a passive manager is not itself a party to any swaps.

Each Fund managed by USCF is a separate legal entity with separate investors and separate investment objectives. USCF is nothing more than a service provider who buys and sells based on the investment decisions of each Funds' investors and each Funds' pre-determined investment objectives. Subjecting USCF and similar passive managers of un-levered passive funds to regulation as a major swap participant would not do anything to enhance the safety and soundness of the United States financial system.

b. Intent of Major Swap Participant Regulation

The Act states that "the Commission shall define by rule or regulation the term 'substantial position' at the threshold that the Commission determines to be prudent for the effective monitoring, management and oversight of entities that are systemically important or can significantly impact the financial system of the United States." Regulation of passive investment managers and/or passive, un-levered commodity funds as "major swap participants" is not necessary for such monitoring, management and oversight. As discussed above with respect to position limits, studies and data have shown that the futures contracts in which the Funds invest do not affect the overall financial system in any meaningful way but merely provide individual investors safe, transparent and efficient access to the futures markets.

In connection with the definition of "substantial position," the Act also requires the Commission to consider a person's relative position in uncleared as opposed to cleared swaps and states that the Commission may take into consideration the value and quality of collateral held against counterparty exposure. The futures trading activity of each Fund is unleveraged, as all futures positions are fully collateralized. Each time a Fund receives a purchase order for a creation basket, the Fund purchases futures contracts in the appropriate commodity that have an aggregate market value of approximately the purchase price received by the Fund for the creation basket. After transferring the required margin for the futures contracts purchased with its futures commission merchant, the Fund then invests the remainder of its proceeds from the creation basket in short term obligations of the United States for two years or less, cash and/or cash equivalents. Through this process each Fund ensures that the value of its liquid assets, whether held by the Fund or posted as margin or collateral, at all times approximates the aggregate market value of its obligations under its futures contracts. Accordingly, we believe that the regulations promulgated by the CFTC should confirm that exchange traded futures invested in by USCF should be completely excluded from the "substantial position" calculation.

As a final point with respect to the phrase "substantial position," assuming that the Funds are required to comply with position limits established by the CFTC pursuant to the Act, then regardless of where or how such position limits are set and regardless of how "substantial position" is calculated, an un-levered, passive fund whose positions do not create risk to the financial system should not be deemed to maintain a substantial position in swaps. We assume that the CFTC will set position limits at levels it considers prudent and effective to achieve the Act's goal of protecting the overall financial system. To the extent that a passive fund is both complying with these position limits and taking additional steps to ensure the safety and soundness of the United States financial markets (i.e., fully collateralizing its positions), such fund should not be deemed to maintain a "substantial position" and should not be regulated as a major swap participant. Our view on this issue is supported by the regulated exchanges that take into account whether a fund is passive and/or un-levered when looking at accountability. Both the NYMEX and ICE generally refrain from taking any action with respect to un-levered, passive funds that reach accountability levels for commodities traded on their exchanges but

generally do take action with respect to actively managed funds who reach the same accountability levels.

The following language will accomplish what we have discussed above:

The Commission will presume that an un-levered, passive, exchange traded commodity fund that (1) has a diversified shareholder base, (2) publishes its portfolio holdings to the public and (3) has holdings below the then-existing position limits, will not be deemed to have a "substantial position" for the purpose of the definition of "major swap participant." Notwithstanding the foregoing, an actively managed private fund with similar sized holdings as any such un-levered, passive, exchanged trade fund may be considered a "major swap participant."

c. Negative Impact of Regulation as Major Swap Participants

The structure of the Funds already subjects them to a significant amount of regulation. The CFTC itself, along with the National Futures Association, already regulate USCF as the commodity pool operator for the funds. In addition, the sale of Fund securities on the NYSE Arca subjects each Fund to comprehensive federal securities regulation by the Securities and Exchange Commission, the Financial Industry Regulatory Authority and NYSE Arca. These regulatory organizations review the offering documents of each Fund and provide ongoing regulatory oversight of the Funds' operations. As part of this oversight, USCF and the Funds are subject to ongoing reporting and disclosure requirements, business conduct standards and regular examinations by the various regulators. As a result, the Funds are different from those currently unregulated derivatives market participants who may engage in a substantial amount of trading in OTC market without complying with any significant regulation. Subjecting the Funds to further regulation by the same regulators who already oversee the Funds' trading activities would not provide any additional protection for the Funds' investors or benefit to the United States financial system. Any additional regulation would only hinder the Funds' abilities to efficiently meet their investment objectives.

IV. Conclusion

We appreciate the Commission's efforts to ensure well-regulated, transparent energy markets. However, we do not believe that the imposition of restrictive position limits or the regulation of passive commodity funds as major swap participants will further the Commission's efforts in this area. In fact, the unintended consequences of the Dodd-Frank Position Limits may lead to even less transparency and more risk for investors in the financial energy markets. Given that the Commission is mandated by the Act to impose position limits, we strongly urge the Commission to add in provisions that would exempt passive, unleveraged investors such as the Funds from any position limits that are adopted, and instead take a "look-through" approach in

order to regulate the positions of individual investors in the Funds. We also urge the Commission to adopt regulations clarifying that passive, unleveraged investors such as the Funds are not major swap participants because regulation of these entities as major swap participants would only hinder their ability to meet their investment objectives without doing anything to protect the United States financial system. By taking these steps, the Commission can ensure that all investors have safe, transparent, and cost-effective access to the hedging benefits provided by the financial energy markets.

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order to regulate the positions of individual investors in the Funds. We also urge the Commission to adopt regulations clarifying that passive, unleveraged investors such as the Funds are not major swap participants because regulation of these entities as major swap participants would only hinder their ability to meet their investment objectives without doing anything to protect the United States financial system. By taking these steps, the Commission can ensure that all investors have safe, transparent, and cost-effective access to the hedging benefits provided by the financial energy markets.

* * *

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Appendix A

Responses to CFTC Request for Comments

The discussion below presents our responses to selected questions posed by the CFTC in the Proposed Rule. These questions, and our corresponding responses, remain relevant to the Dodd-Frank Position Limits, since the Commission will have to address similar issues when developing a new proposed rule on position limits. We first address Question 15, which is specifically directed at the operation of the Funds, and then respond to various of the other questions in the Proposed Rule.

Question 15. *Concerns have been raised about the impact of large, passive, and unleveraged long-only positions on the futures markets. Instead of using the futures markets for risk transference, traders that own such positions treat commodity futures contracts as distinct assets that can be held for an appreciable duration. This notice of rulemaking does not propose regulations that would categorize such positions for the purpose of applying different regulatory standards. Rather, the owners of such positions are treated as other investors that would be subject to the proposed speculative position limits.*[31]

The series of questions that follow are presumably directed to the activities of entities like the Funds. We believe that the suggestion that the Funds' investors somehow represent a new category of market participant overlooks the various reasons why people and institutions invest in the Funds. Energy prices effect every institution and every individual in our society, thus increased prices have implications for every business and every individual. We believe that it is more appropriate to characterize investments in the Funds as a hedge against the economic effects of higher energy costs rather than as "distinct assets that can be held for an appreciable duration." Investment in the Funds reduces the adverse impact of higher energy prices on our investors and, conversely, losses incurred on investments in the Funds when energy prices decline are generally offset by savings in actual energy costs. It is certainly possible for investors to purchase shares in the Funds for speculative purposes, but it is highly doubtful that any such investors would themselves exceed the Commission's proposed speculative position limits and we would welcome any efforts by the Commission to identify and regulate such individual investors.

Just as there is a clear rationale for exempting the hedging transactions of commercial entities, we believe there is an equally compelling rationale for exempting the hedging

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[31] We note that this question refers to passive investments in "long-only positions" in futures contracts, but not to short-only positions that are similarly passive and unleveraged. Given the fact that there is both a long and a short side to each futures contract, we believe that short-only investments should be given the same treatment as long-only positions in futures contracts. The United States Short Oil Fund, LP, managed by USCF, is an example of an entity that makes passive, unleveraged short-only investments.

transactions of non-commercial energy consumers. Before the advent of collective investment vehicles such as those presented by the Funds, there was simply no need to consider this issue because individual non-commercial energy consumers would never exceed speculative position limits. Indeed, we believe that if every investor in our Funds were to participate directly in the energy products traded on regulated markets there would be no thought given to trying to limit their aggregate positions. Given the passive nature of the Funds and the fact that Fund purchases/sales of futures contracts correlate directly to the investment decisions of individual investors, we do not believe that the investments of the Funds should be aggregated for purposed of any proposed position limits.

a. Should the Commission propose regulations to limit the positions of passive long traders?

No. The rationale set forth in the Proposed Rule does not apply to the positions in such contracts held by passive long (or short) traders such as the Funds. In the Proposed Rule, the Commission states that "[l]arge concentrated positions in the energy futures and option markets can potentially facilitate abrupt price movements and price distortions."[32] Given that the positions of the Funds are generally passive (in that they increase or decrease only in response to additional investments in or withdrawal of assets from the Funds), it seems self-evident that they should not facilitate "abrupt price movements and price distortions." Further, USCF has publicly disclosed data refuting any notion that the activities of its Funds cause sharp movements in or distortions of their relevant commodity markets. For example, a Form 8-K was filed with the Securities and Exchange Commission on July 24, 2009, showing that wide swings in the price of natural gas were not the result of the activities of UNG.[33] For example, data shows that during the run-up in natural gas prices during the time period of September 2007 and $5.50 per Million BTU ("mbtu"), to July 2008, and roughly $13.50 mbtu, UNG's holdings in natural gas futures contracts were essentially flat. UNG owned 8,093 contracts on September 7, 2007, and owned 8,587 contracts on July 3, 2008. We do not believe that this data supports the notion that UNG's investing activities could have been a driving force behind the increase in natural gas prices over this time period. Indeed the evidence included in the July 24, 2009 Form 8-K suggests from data available to us that the Funds' activity in the market tends to curb price movements rather than exacerbate them; investment in the Funds tends to increase when prices are falling and decrease when prices are rising.

USCF has also publicly disclosed information refuting charges that the large size of USO will lead to USO's trading activities distorting prices in the oil futures contract market. In a

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[32] Proposed Rule, at 4148.

[33] http://www.sec.gov/Archives/edgar/data/1376227/000114420409038643/v155515_8k.htm.

Form 8-K filed with the Securities and Exchange Commission on February 4, 2010,[34] USO's management presented data after reviewing the history of creation and redemption orders since USO was listed in April of 2006 through the end of January 2010. During that time, USO processed creation and redemption orders on 705 different days. The average size of daily creation or redemption orders received by USO led it to purchase or sell on average approximately 820 crude oil futures contracts. USO's management noted in its Form 8-K that in 2009, the combined average number of light, sweet crude oil contracts traded ***each day*** on the NYMEX and ICE, exceeded 850,000 contracts. As a percentage of daily volume in the light, sweet crude oil futures market, USO's creation and redemption activity has averaged around 1/10 of 1%.

USO's management further reviewed the history of USO's creations and redemptions to determine the size of the transactions on the dates where USO had its greatest amount of creation activity, and the greatest amount of redemption activity, since its inception. USO's most active single day for creation activity occurred on January 28, 2009. That day's creation activities in turn led to an increase in the total number of USO units outstanding of 10.8%. Those creations resulted in the purchase of 7,451 light, sweet crude oil futures contracts by USO. However, on that date, the combined number of light, sweet crude oil futures contracts of the same contract month as purchased by USO that traded on NYMEX and ICE totaled over 381,000. Therefore, on the day during which USO had its largest amount of creation activity, USO's purchased futures contracts equal less than 2% of that day's volume in that one contract month. Stated another way, USO's selling activity that day was roughly equal to the amount of trading on NYMEX and ICE that occurred every 7 minutes.

As highlighted in the Form 8-K referenced above, USO's redemption activity has a similarly minimal market impact when viewed both from a daily average and largest single trading day perspective. Thus objective data supports the notion that merely having large passive funds active in the financial commodity markets does not cause price distortion, because these funds represent only a small fraction of the total trading in such markets.

Allegations have also been made to suggest that large passive investment vehicles like the Funds cause price distortion in the financial commodity markets when they "roll" their positions in near month futures contracts into next (or other) month contracts on a predetermined basis in order to meet their investment objectives. USO publicly refuted this charge with data provided in a Form 8-K filed with the SEC on January 28, 2010, which is described below.[35]

As explained in the aforementioned Form 8-K, since the end-of-day settlement prices of the futures contracts for light, sweet crude oil as well as USO's daily holdings and roll schedule

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[34] http://www.sec.gov/Archives/edgar/data/1327068/000114420410005550/v173243_8k.htm.

[35] http://www.sec.gov/Archives/edgar/data/1327068/000114420410004013/v172435_8k.htm.

are all publicly available, USO's management was able to determine what the price spreads were immediately prior to USO's roll, what they were during the roll and what they were immediately after the roll was concluded. Since the crude oil futures market was in contango throughout 2009, if USO's rolls were affecting the prices of crude oil futures contracts, one would expect that the price spreads would have widened as a result of each monthly roll. However, as shown below, this was not the case. Instead, the price spreads actually narrowed half the time.

The table below measures the changes in the spread during 2009 in two fashions. The first compares the price spread between the nearest month to expiration contract and the next nearest month to expiration contract on the last day before USO's roll began and compares it to the average price spread during USO's roll. The second measurement compares the average price spread between the nearest month to expiration contract and the next nearest month to expiration contract on the four days before USO's roll began and compares it to the average price spread during USO's roll.

Number of Months	Prior Day versus Average of USO's Roll	Average of Prior Four Days versus Average of USO's Roll
Price Spread Widened	6	7
Price Spread Narrowed	6	5

In addition, on five of the six occasions where the price spread widened between the last day prior to the roll and the roll itself, the price spread was still wider even after USO's roll was over. On five of the seven occasions where the price spread widened between the average of the four prior days and the roll itself, the price spread was also still wider after USO's roll was complete. USO's management believes that this suggests that other factors, such as inventory storage buildups, were at play in determining the price spread both before, during, and after USO's roll period, and that empirical data supports the fact that USO's activities have not systematically and predicatively caused changes in the spread between the price of nearest month to expiration and the next nearest month to expiration crude oil futures contracts as some have alleged.

Finally, the Commission also stated, as a rationale for the Proposed Rule, that "[c]oncentration of large positions in one or a few traders' accounts can also create the unwarranted appearance of appreciable liquidity and market depth. Trading under such conditions can result in greater volatility than would otherwise prevail if traders' positions were more evenly distributed among market participants."[36] Again, these concerns do not apply to the Funds' investments in energy futures. First, the Funds' participation in the markets is fully transparent, with the trading positions of each Fund publicly accessible on their websites. Anyone trading in these markets has the opportunity to know about the extent of the Funds' positions and on what basis they trade. Second, as previously discussed, the Funds are passive

[36] Proposed Rule, at 4149.

participants and only enter the market to buy or sell futures based on the investment decisions of the owners of the Funds. Thus, from a volatility perspective, the trading activities of the Funds are effectively "distributed among market participants," *i.e.*, the Funds' hundreds of thousands of investors.

b. If so, what criteria should the Commission employ to identify and define such traders and positions?

As noted above, we do not believe that the Commission should limit the positions of passive long (or short) traders, but rather that these traders should be exempted from any position limits adopted by the Commission. In determining which entities should be provided with exemptions from position limits, the Commission should employ factors similar to those it previously used in providing no-action relief to certain index-based funds from position limits on agricultural products.[37] These factors include the following key elements:

(i) *The futures trading activity passively tracks a widely recognized commodity benchmark.*

(ii) *The futures trading activity is unleveraged.*

(iii) *Both the commodity benchmark and the fund are highly transparent.*

(iv) *The futures trading does not result in price exposure for the fund.*

Applying these factors would ensure that all exempted entities would be acting in a way that would not negatively affect the financial energy markets and also provide appropriate safeguards to inform and protect potential investors.

c. Assuming that passive long traders can properly be identified and defined, how and to what extent should the Commission limit their participation in the futures markets?

The Commission should not limit the participation of publicly traded and regulated passive long (or short) traders like the Funds, but rather continue to monitor these market participants and possibly take additional steps to ensure that investors are not utilizing these entities to avoid speculative position limits. Such steps might include reporting requirements for individual investors in the Funds beyond those required by the SEC and the exchange to ensure that their individual positions do not rise above any position limits that are adopted.

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[37] CFTC Letter 06-09 (April 19, 2006); CFTC Letter 06-19 (September 6, 2006).

d. If passive long positions should be limited in the aggregate, would it be feasible for the Commission to apportion market space amongst various traders that wish to establish passive long positions?

As noted above, we see no reason why these positions should be limited in the aggregate unless, on a look through basis, an individual investor has positions in excess of the speculative position limits.

e. What unintended consequences are likely to result from the Commission's implementation of passive long position limits?

As previously discussed, we have no reason to believe that investor interest in the financial energy markets is likely to be curtailed by the Commission's Proposed Rule on position limits. To the contrary, all the evidence points to growing investor interest in gaining exposure to these markets. Moreover, there are any number of ways in which the Commission's proposed position limits can be avoided or circumvented by investors seeking access to these markets, including the use of OTC and foreign markets, and the creation of additional funds created by new sponsors to tap investor demand that cannot be satisfied by the existing funds. In either case, the impact, if any, on participation in the energy futures markets will likely be the same as if the proposed limits were either abandoned or modified to provide a "look-through" to the actual investors of passive funds. As a result of the foregoing, the Commission's Proposed Rule may directly cause the migration of trading away from our regulated futures markets to the OTC and foreign markets. This migration would be in direct opposition to the Commission and other financial regulators' efforts to move trading from the OTC markets to the regulated futures markets in order to promote transparency and reduce systemic risk.

Question 1. *Are Federal speculative position limits for energy contracts traded on reporting markets necessary to "diminish, eliminate, or prevent" the burdens on interstate commerce that may result from position concentrations in such contracts?*

Whatever the case may be for imposing speculative position limits for energy contracts traded on reporting markets for market participants who are active managers of financial investments, or who are financial intermediaries such as swap desks, or who are producers/end-users/physical traders of the underlying commodities, the case has not be made that such limits should be imposed on passive, un-levered, exchange traded pass-through vehicles such as the Funds. The Funds are passively managed and employ a "neutral" investment strategy intended to track changes in the price of a benchmark commodity regardless of whether the price goes up or down. Thus, the Funds themselves do not engage in speculative activities in the futures markets. Certain of the Funds' investors may indeed be motivated by the desire to speculate on the price of the respective commodities; however, other investors no doubt participate in order to hedge their commodity price risk exposure. Any Commission rule regarding speculative limits

should look through the Funds to their respective investors in determining whether positions limits should apply. Otherwise, the Commission will potentially penalize hundreds of thousands of investors who have no speculative intent and are merely seeking to hedge their commodity exposures in a commercially efficient manner.

Question 2. *Are there methods other than Federal speculative position limits that should be utilized to diminish, eliminate, or prevent the burdens?*

Yes. The Funds are "passive" investors in futures contracts and only increase or decrease their participation in the futures markets based on purchases or sales of Fund units.[38] The Funds do not seek to "profit" from either increases or decreases in commodity prices and thus do not pose the risks presented by speculators seeking to time market movements. It has been alleged that the Funds large presence in the futures markets creates inappropriate market disruptions as a result of the Funds' need to regularly roll their futures investments from the current month's contract to the following month's contract in order to achieve their investment objectives. This is accomplished in a transparent manner with the Funds publishing their planned rolls on their website. As rationale for the Proposed Rule, the Commission stated that "[l]arge concentrated positions in the energy futures and option markets can potentially facilitate abrupt price movements and price distortions."[39] The data provided in USO's Form 8-K dated January 28, 2010, discussed above, refutes this claim and conforms with the fact that we have seen no evidence that the Funds' large positions facilitated "abrupt price movements" or "price distortions." However, we believe that the Commission should continue to examine the impact, if any, of the Funds' market activity during the roll periods to determine whether any additional steps could be taken to make those activities even more transparent and assure the Commission that there is indeed no adverse market impact. Additionally, as previously noted, we support any efforts by the Commission to regulate the positions of individual investors in entities such as the Funds in order to ensure that individual investors do not exceed any adopted position limits.

Question 3. *How should the Commission evaluate the potential effect of Federal speculative position limits on the liquidity, market efficiency and price discovery capabilities of referenced energy contracts in determining whether to establish position limits for such contracts?*

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[38] The Funds only buy or sell futures in response to actions by their investors. In this sense, the Funds' situation is analogous to that of mutual funds, commodity pool operators and commodity trading advisors that are "eligible entities" under CFTC Regulation § 151.1(e). The existing regulations exempt the positions of these entities from position limits because "the account controllers for these positions are acting independently." Proposed Rule, at 4149–4150. The exemption is limited by the requirement that "the overall positions held or controlled by each such independent account controller may not exceed the [specified limits]..." CFTC Regulation § 150.3(a)(4). We believe the same "independent account controller" "look-through" principles should apply to the Funds.

[39] Proposed Rule, at 4148.

We strongly believe that the Commission should seek to determine on both a qualitative and quantitative basis how Federal speculative position limits could adversely affect the ability of investors to participate in our regulated futures markets. From our perspective, this is an essential question of "market efficiency." As previously noted, we question whether the activities of the Funds should properly be covered by "speculative" position limits. The growth of the Funds in recent years attests to the interest of a very wide spectrum of investors in the cost efficient mechanism offered by the Funds for gaining exposure to market energy prices. For the most part, we believe that exposure is intended to hedge the energy price exposure that they face in meeting their daily business and/or individual investments or energy needs. To characterize the Funds' investors as speculators is, in our view, a mischaracterization of the primary motive for investment in the Funds. To the extent that new Federal speculative position limits will preclude the Funds from accepting new business or cause potential Fund investors to incur additional costs and expense and thus become less efficient, these investors will be harmed. We believe it is incumbent upon the Commission to assess this harm to "market efficiency" in deciding whether they outweigh any supposed benefits to be derived from imposing new Federal speculative limits.

Question 8. *Proposed regulation 151.3(a)(2) would establish a swap dealer risk management exemption whereby swap dealers would be granted a position limit exemption for positions that are held to offset risks associated with customer initiated swap agreements that are linked to a referenced energy contract but that do not qualify as bona fide hedge positions. The swap dealer risk management exemption would be capped at twice the size of any otherwise applicable all-months-combined or single non-spot-month position limit. The Commission seeks comment on any alternatives to this proposed approach. The Commission seeks particular comment on the feasibility of a "look-through" exemption for swap dealers such that dealers would receive exemptions for positions offsetting risks resulting from swap agreements opposite counterparties who would have been entitled to a hedge exemption if they had hedged their exposure directly in the futures markets. How viable is such an approach given the Commission's lack of regulatory authority over the OTC swap markets?*

The Funds do not support the Commission's proposal to establish a new swap dealer risk management exemption. This proposal seems mere window dressing on the more fundamental decision to preclude swap dealers from relying upon the existing bona fide hedging exemption and represents a back-door effort to curtail the OTC market for energy transactions. The proposed prohibition on swap dealers holding any speculative positions while relying on the swap dealers exemption seems particular onerous, particularly given the Commission's proposed rules regarding aggregation of positions.

However, to the extent that the Commission is acknowledging that there should be a "look-through" exemption for entities like the dealers that are merely holding futures positions to

hedge positions taken with their customers and the decision as to whether to buy or sell such positions effectively rests with those customers, such an exemption may be appropriate

Question 13. *The Commission notes that Congress is currently considering legislation that would revise the Commission's section 4a(a) position limit authority to extend beyond positions in reporting market contracts to reach positions in OTC derivative instruments and FBOT contracts. Under some of these revisions, the Commission would be authorized to set limits for positions held in OTC derivative instruments and FBOT contracts. The Commission seeks comment on how it should take this pending legislation into account in proposing Federal speculative position limits.*

In light of the pending legislation dealing with the Commission's authority to establish speculative position limits, we believe it would be in the public interest to defer action on the current Proposed Rule until Congress enacts new regulatory reform legislation. As noted previously, one likely consequence of adopting the current proposal would be to encourage market participants to either move trades from regulated U.S. markets to the OTC markets or FBOT contracts. Given the widely held view that systemic risk is reduced where trading occurs on regulated exchanges and trades are cleared by central clearing entities, it does not seem appropriate at this time to adopt these new rules.