

CFTC Reproposes Rules On Position Limits for Futures and Swaps

Overview

On November 5, 2013, the Commodity Futures Trading Commission (the “Commission”) approved the issuance of a proposal to expand its rules concerning speculative position limits (the “Proposed Rules”). The Proposed Rules would establish Commission-mandated limits for speculative positions in futures and options contracts on 28 agricultural, energy and metals commodities as well as economically equivalent futures contracts, options contracts, and swaps. In connection with establishing these limits, the Proposed Rules would add and amend certain definitions, revise the exemptions from speculative limits, including for bona fide hedging, and add reporting requirements for persons claiming exemptions from the limits. The Commission is seeking comment until 60 days from the date of publication of the Proposed Rules in the Federal Register.

The Commission had released amended final rules governing speculative position limits on October 26, 2011 (see our [Alert](#)), and subsequently proposed modifications to the aggregation provisions of those final rules on May 30, 2012 (see our [Alert](#)). However, the final rules were vacated in an Order dated September 28, 2012 by the District Court for the District of Columbia.¹ The aggregation provisions were repropose on November 15, 2013 and are discussed in a separate [Alert](#).

Speculative Position Limits

Under the Proposed Rules, a speculative position limit is defined as the maximum position, either net long or net short, in certain commodity derivative contracts that may be owned or controlled by one person, absent an exemption. Speculative position limits apply separately to positions in the spot month² and in non-spot months.

Contracts Subject to the Proposed Position Limits

Positions in “referenced contracts” are subject to the proposed speculative position limits. Referenced contracts are the 28 core referenced futures contracts listed in Proposed Rule 150.2(d)³ and economically equivalent futures contracts, options contracts, and swaps. A futures contract, options contract or swap is considered “economically equivalent” if it is (i) directly or indirectly linked, including being partially or fully settled on, or priced at a differential to, the price of a core referenced futures contract or (ii) directly or indirectly linked, including being partially or fully settled on, or priced at a differential to, the price of the same commodity underlying that particular core referenced futures contract for delivery at the same locations as specified in that particular core referenced futures contract. However, the proposed definition of referenced contracts does not include a guarantee of a swap, a basis contract or a commodity index contract.

¹ See *International Swaps and Derivatives Association v. United States Commodity Futures Trading Commission*, 887 F. Supp.2d 259 (D.D.C. 2012).

² “Spot month” is the trading period immediately preceding the delivery period for a physical-delivery futures contract as well as for any cash-settled swaps and futures contracts that are linked to the physical-delivery contract.

³ The 28 core referenced futures contracts are: Chicago Board of Trade Corn, Oats, Rough Rice, Soybeans, Soybean Meal, Soybean Oil and Wheat; Chicago Mercantile Exchange Feeder Cattle, Lean Hogs, Live Cattle and Class III Milk; Commodity Exchange, Inc. Gold, Silver and Copper; ICE Futures U.S. Cocoa, Coffee C, FCOJ-A, Cotton No. 2, Sugar No. 11 and Sugar No. 16; Kansas City Board of Trade Hard Winter Wheat; Minneapolis Grain Exchange Hard Red Spring Wheat; and New York Mercantile Exchange Palladium, Platinum, Light Sweet Crude Oil, New York Harbor ULSD, RBOB Gasoline and Henry Hub Natural Gas. Note that the Commission expects to propose to expand the list of core referenced futures contracts in physical commodities in the future.

Additionally, referenced contracts traded on foreign boards of trade are subject to speculative position limits provided that (i) such referenced contracts settle against any price (including the daily or final settlement price) of one or more contracts listed for trading on a designated contract market (“DCM”) or swap execution facility (“SEF”), and (ii) the foreign board of trade makes available such referenced contracts to its members or other participants located in the United States through direct access to its electronic trading and order matching system.

Spot Month Position Limits

Under the Proposed Rules, spot month position limits for referenced contracts would be calculated separately for physical delivery referenced contracts and for cash settled referenced contracts. Initially, limits would be set to the levels in Proposed Appendix D to Part 150 of the Commission Rules, which correspond to the existing spot month limits established by the exchanges. At least every two years thereafter, the Commission would set subsequent spot month limits at levels not greater than one-quarter of the estimated spot month deliverable supply in the relevant core referenced futures contract, but not less than 1,000 for referenced contracts in an agricultural commodity or 5,000 in an energy or metals commodity. A conditional spot month limit exemption would permit a person to own or control positions up to five times the spot month limit if such positions are exclusively in cash-settled contracts.

Non-Spot Month Position Limits

The Commission proposed setting limits for positions in a single month (other than the spot month) of a particular referenced contract and in all-months-combined of a particular referenced contract at the same level. Initially, the all-months-combined limit would be set to the level in Proposed Appendix D to Part 150 of the Commission Rules. The Commission would set subsequent all-months-combined limits no less frequently than every two years, based on 10% of the estimated average open interest in referenced contracts for the first 25,000 contracts, and 2.5% of open interest for amounts above 25,000.

Pre-existing Positions

Pre-existing positions in spot month referenced contracts would be subject to the proposed position limits. The single month or all-months-combined limit would not apply to pre-existing positions in a non-spot month contract acquired in good faith prior to the effective date of the limit. However, any increase in non-spot month contracts would cause the entire position to be included in the calculation of the single month or all-months-combined limit. Notwithstanding the foregoing, speculative limits would not apply to positions acquired in good faith in any swap entered into prior to 60 days after the final rules are published in the Federal Register. However, such swaps positions may be netted with post-effective date referenced contracts for the purpose of complying with any single month or all-months-combined position limit.

Position Limit Exemptions

Consistent with current practice, proposed Part 150 exempts certain positions from speculative limits. Notably, the Proposed Rules continue to exempt positions held for bona fide hedging, but narrow the scope of the definition of bona fide hedging position. Consequently, proposed Part 150 would reduce the positions that qualify for the bona fide hedging exemption. As discussed in greater depth below, the Proposed Rules also

contain an exemption for positions held by persons in financial distress circumstances and a conditional exemption from spot month speculative position limits.

Bona Fide Hedging

The Proposed Rules delete the current definition of “bona fide hedging transactions or positions” in Rule 1.3(z) and replace it with a new definition of “bona fide hedging position” in Rule 150.1. Consistent with current Rule 1.3(z), the Proposed Rules set forth two general requirements for any bona fide hedging position: (i) the purpose of the position must be to offset price risks incidental to commercial cash operations; and (ii) the position must be established and liquidated in an orderly manner in accordance with sound commercial practices. While the Proposed Rules increase the number of enumerated hedges relative to current Rule 1.3(z), the scope of bona fide hedging positions is reduced. For example, swap risk management positions that were previously considered bona fide hedges under Commission Rule 1.47 would be subject to the proposed position limits if such swaps positions are entered into after the effective date of a final position limits rule.

In order for a position in an excluded commodity (i.e. interest rate and exchange rate derivatives) to qualify as a bona fide hedging position, the position also must be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise and either be an enumerated hedging position (as defined below) or be recognized as a bona fide hedging position by a DCM or SEF, consistent with the Commission’s 1987 risk management guidance as incorporated into Proposed Appendix A to Part 150.

For a position in a physical commodity derivative to be considered a bona fide hedge, the position also must (i) represent a substitute for a transaction made or to be made in a physical marketing channel; (ii) be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and (iii) arise from the potential change in the value of certain assets, liabilities or services. Moreover, the position must be an enumerated hedging position. A person who uses a swap to reduce risks attendant to a position that qualifies as a bona fide hedging position may pass-through those bona fides to the counterparty, even if the person’s swap position is not in excess of a position limit. Positions in commodity derivative contracts that reduce the risk of pass-through swaps would qualify as bona fide hedging positions. However, a person relying on this “pass-through swap” exemption would be required to obtain a written representation from its counterparty that the swap qualified as a bona fide hedging position, and would be subject to reporting requirements.

The Proposed Rules set forth the following categories of enumerated hedges: (1) hedges of inventory and cash commodity purchase contracts; (2) hedges of cash commodity sales contracts; (3) hedges of unfilled anticipated requirements; (4) hedges by agents; (5) hedges of unsold anticipated production; (6) hedges of offsetting unfixed-price cash commodity sales and purchases; (7) hedges of anticipated royalties; and (8) hedges of services. In addition, the proposal includes an enumerated hedge category for cross-commodity hedges that would apply to the other types of enumerated hedges and also to pass-through swaps. Finally, persons seeking relief for certain qualifying non-enumerated risk-reducing transactions may apply for an interpretative letter or exemptive relief.

Additional Exemptions

In addition, the Commission has proposed an exemption for positions held by persons in financial distress circumstances and a conditional exemption from spot month speculative position limits. Under the proposed financial distress exemption, upon request to the Commission, the CFTC may exempt a person under financial distress circumstances for a time certain from speculative position limits. Financial distress circumstances

include situations involving the potential default or bankruptcy of a customer of the requesting person, an affiliate of the requesting person, or a potential acquisition target of the requesting person. Additionally, as noted above, the Proposed Rules provide a conditional exemption from the spot month position limits that permit a person to own or control positions up to five times the spot month limit if such positions are exclusively in cash-settled contracts. This exemption would be available only to traders who do not own or control positions in the spot month physical delivery reference contract and would trigger enhanced reporting of cash market holdings to the Commission.

Reporting and Recordkeeping Requirements

The proposal also would make changes to the Commission's reporting rules. Under the revised rules, market participants would use revised Commission Forms 204 and 304 to report certain cash market positions. Cash positions related to conditional spot month exemptions, pass-through swap exemptions and anticipatory hedging exemptions would be reported on new CFTC Forms 504, 604 and 704, respectively. All persons who avail themselves of an exemption from the speculative position limits under the Proposed Rules would have to comply with additional recordkeeping requirements and would be subject to periodic calls by the Commission.

Exchange-Set Speculative Position Limits

Under the Proposed Rules, DCMs and SEFs would be required to adopt position limits at a level no higher than the Commission's limit for all referenced contracts, but position accountability requirements could be adopted in lieu of position limits for excluded commodities, as well as for physical commodities that are not subject to a Commission position limit. A DCM or SEF that adopts position accountability levels could be required to adopt spot-month limits in certain circumstances. The Commission proposal also requires DCMs and SEFs to adopt aggregation rules and bona fide hedging exemptions that are at least as stringent as Commission requirements. As noted above, the Proposed Rules would also allow DCMs and SEFs to adopt risk management exemptions for excluded commodities.

Please contact [Deborah Monson](#) or the Ropes & Gray attorney who normally advises you with any questions you may have or if you would like additional information.