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Recent CFTC Enforcement Action against Non-U.S. Fund Manager for Violation of U.S. Position Limits Highlights Traps for the Unwary

By: Deborah A. Monson, Partner, and Jeremy A. Liabo, Associate, Ropes & Gray LLP

Recent enforcement actions by the United States Commodity Futures Trading Commission ("CFTC" or the "Commission") and the Chicago Board of Trade ("CBOT") against Elephas Investment Management Limited ("Elephas"), a hedge fund manager located in Hong Kong that is not registered with the CFTC, for violating speculative position limits serves a reminder to asset managers and other market participants of the need to have in place a robust position limits compliance program.

Elephas was found to have carried into the spot month a futures equivalent net long position of 1,680 December 2017 CBOT soft red winter wheat futures contracts, which exceeded the CFTC and CBOT spot month limit by over 1,000 contracts (180%). Elephas reduced its position below the limit the next day. As a result of the violation, Elephas was ordered to pay a civil monetary penalty to the CFTC of $160,000, a fine of $50,000 to the CBOT and a disgorgement of the $165,590 benefit it received in reduced losses.[1]

The actions against Elephas highlight the traps for unwary asset managers and other market participants who trade products subject to position limits. Below is a list of key considerations that asset managers should take into account when designing their position limits compliance program.

Applicable to all Market Participants

Position limits are applicable to all market participants regardless of whether they are in the U.S. or not, and regardless of whether they are registered with the CFTC or not. By trading on a U.S. exchange, market participants are subject to these limits.

Applicable to Options Positions

Futures position limits also apply to options on futures. Options positions must be converted to their futures equivalent positions using a formula established by the exchange on which the contract is listed and aggregated with existing futures positions.

Change over the Life of the Contract

Position limits may change throughout the life of a contract. In particular, once a contract enters the spot month it may be subject to a limit that is materially lower than the prior limit.

Subject to Periodic Amendment

Position limits may be amended by the CFTC and the exchanges from time to time. The amended limits are published by the CFTC and the exchanges in advance of the effective date.

The date on which the spot month begins is set on a contract by contract basis and may change from month to month.

Violations are Subject to Strict Liability

Position limit violations are subject to strict liability, so intent is irrelevant and it is relatively straightforward for regulators to determine that a violation occurred.

Apply on an Aggregated Basis

Position limits generally apply to the aggregate of all positions owned or controlled by an asset manager or other market participant. Subject to certain exceptions, such a firm must aggregate all positions in accounts or funds for which it directly or indirectly controls trading or holds a 10% or greater ownership interest, as well as those held by any other person with whom it trades pursuant to an express or implied agreement.

Violations Subject Managers to Prosecution by Multiple Regulators

Penalties for position limit violations typically include a fine, which may be assessed by multiple regulators for the same violation, and the disgorgement of any benefit received as a result of the overage, such as any profit or reduction in loss. In addition, the violation will be publically announced by the regulator(s) that brought the action and published in databases available to the public.

The Elephas action highlights the importance of having a thorough understanding of the applicable rules and how they work, and of having a robust position limit compliance program. Looking forward, market participants should keep in mind that the CFTC has proposed amendments to its position limits rules.

Anticipated Changes to the CFTC's Position Limit Rules

New CFTC Chairman Heath Tarbert has indicated recently that finalizing the Commission's long awaited derivatives position limits rules is a top priority. We anticipate the new rules may, among other things: (1) expand the scope of products to which CFTC limits apply to include certain swaps and a broader group futures and options on futures; (2) amend existing position limit exemptions, including the definition of bona fide hedging; and (3) change the process for establishing limits.

Importantly, the new rules are not likely to alleviate many of the key considerations highlighted above. Consequently, asset managers and other market participants are well advised to assess the sufficiency of their position limit compliance program now, so that they are best positioned before the scope of products to which limits apply expands.

1 Elephas' loss on the position would have been greater had it reduced its position before entering the spot month. The CBOT therefore ordered Elephas to disgorge the amount by which its loss was reduced as a result of the violation.

BusinessConsulting@wellsfargo.com

www.wellsfargo.com/primeservices