

## Commodity Futures Trading Commission Announces Final Rule on Position Limits for Futures and Swaps

### Overview

On October 26, 2011, pursuant to the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the “Dodd-Frank Act”), the Commodity Futures Trading Commission (the “CFTC”) released final rules (the “Final Rule”)<sup>1</sup> which establish CFTC-administered speculative position limits for 28 physical delivery commodity futures and options contracts, as well as for swaps that are economically equivalent to such contracts. The Final Rule is expected to be published in the Federal Register shortly.

### Background

The Final Rule was adopted under the financial reform regulatory regime of the Dodd-Frank Act and seeks to address concerns over excessive speculation and market manipulation in commodity markets. Title VII of the Dodd-Frank Act amended the *Commodity Exchange Act* and charged the CFTC with setting spot month, single-month and all-months-combined position limits for certain physical commodity and cash-settled derivatives at levels that would serve “(i) to diminish, eliminate or prevent excessive speculation as described under this section; (ii) to deter and prevent market manipulation, squeezes and corners; (iii) to ensure sufficient market liquidity for *bona fide* hedgers; and (iv) to ensure the price discovery function of the underlying market is not disrupted.”<sup>2</sup> The CFTC published the proposed rules for position limits on January 26, 2011 (the “Proposed Rule”) and accepted public comment on the Proposed Rule through March 28, 2011. The Final Rule was adopted on October 18, 2011 at a public meeting of the CFTC, during which the CFTC voted 3 to 2 to adopt the Final Rule.

### Referenced Contracts

The Final Rule applies CFTC-administered speculative position limits to 28 physical delivery commodity futures and options contracts (the “core referenced futures contracts”), as well as to swaps that are economically equivalent to such contracts (together with the core referenced futures contracts, the “referenced contracts”). A futures 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 any 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 location or locations as specified in that particular core referenced futures contract. The CFTC clarified that the term “referenced contracts” includes (i) the core referenced futures contract, (ii) contracts that settle off of the core referenced futures contract and contracts that are based on the same commodity for the same delivery location as the core referenced futures contract, (iii) contracts with a reference price based only on the combination of at least one referenced contract price and one or more prices in the same or substantially the same commodity as that underlying the relevant core referenced futures contract, and (iv) intercommodity spread with two components, one or both of which are referenced contracts. The CFTC further clarified that if a swap contract that utilizes as its sole floating reference price the prices generated directly or indirectly from the price of a single core referenced futures contract, then it is subject to speculative position limits.

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<sup>1</sup> 17 CFR 151

<sup>2</sup> Section 4a(a)(3) of the Commodity Exchange Act.

## Spot Month Position Limits

In the first phase of implementation, the Final Rule imposes spot-month position limits. The initial spot month position limits will be set at the CFTC limits for the nine “legacy” agricultural commodities subject to current CFTC limits and will be set at exchange-set limits based on estimated spot month deliverable supply for the other referenced contracts. Thereafter, such spot month limits will be based on 25% of the CFTC-estimated spot month deliverable supply. The Final Rule eliminates the broader conditional spot month position limits set forth in the Proposed Rule. Spot month position limits were proposed to apply differently to physical delivery referenced contracts and to cash-settled referenced contracts. However, in the Final Rule, the CFTC adopted, on an interim basis, a spot month position limit for cash-settled contracts (other than natural gas) that will be set a 25% of estimated deliverable supply, in parity with the methodology for setting spot month limit levels for the physical delivery core referenced futures contracts. The CFTC is inviting comments on this interim final rule and suggestions as to alternatives. The comment period on this interim final rule will close 60 days following publication of the Final Rule in the Federal Register. The Final Rule provides that the spot month position limits will be adjusted annually for non-legacy agricultural commodities and every two years for energy and metal commodities.

## Non-Spot Month Position Limits

In the second phase of implementation, the Final Rule provides for non-spot month position limits based on the overall open interest for a particular referenced contract. The nine “legacy” agricultural referenced contracts will be subject to increased non-spot month limits initially and thereafter will be subject to non-spot month limit levels that will be reset pursuant to future CFTC rulemakings, consistent with the approach taken historically. For all other referenced contracts, the non-spot month position limits will be effective by CFTC order after the CFTC has received one year of aggregate open interest data. The general formula will set non-spot month position limits as the sum of 10% of the first 25,000 contracts of average all-months combined aggregated open interest, and 2.5% of the open interest for any amounts above 25,000 contracts. Note that for purposes of the non-spot month position limits, physically delivery referenced contracts and cash-settled referenced contracts will be netted, and the position limits will be applied to the combined total. Non-spot month position limits for non-legacy referenced contracts will be adjusted every two years and based on the higher of (i) most recent 12 months average all-months-combined aggregate open interest or (ii) 24 months average all-months-combined aggregate open interest. The Final Rule eliminates the class specific non-spot month position limits set forth in the Proposed Rule.

## Bona Fide Hedge Exemption

The new statutory definition of *bona fide* hedging transactions or positions pursuant to the Dodd-Frank Act generally follows the current CFTC definition of *bona fide* hedging, with two significant differences. First, the statutory provision recognizes a position in a futures contract established to reduce the risks of a swap position as a *bona fide* hedge, provided that either (i) the counterparty to such swap transaction would have qualified for a *bona fide* hedging transaction exemption (the “pass-through” of the *bona fides* of one swap counterparty to another); or (ii) the swap meets the requirements of a *bona fide* hedging transaction. Second, a *bona fide* hedging transaction or position must represent a substitute for a physical market transaction.

Under the Final Rule, a trader may exceed the position limits set forth in the Final Rule to the extent that a transaction or position in a referenced contract (i) represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel; (ii) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; (iii) arises from the potential change in the value of (A) assets that a person owns, produces, manufactures, processes or

merchandises or anticipates owning, producing, manufacturing, processing or merchandising, (B) liabilities that a person owns or anticipates incurring, or (C) services that a person provides or purchases, or anticipates providing or purchasing; or (iv) reduces risks attendant to a position resulting from a swap that was executed opposite a counterparty for which the transaction will qualify as a *bona fide* hedging transaction pursuant to, or that meets the requirements of, (i) through (iii) above.

In response to comments on the Proposed Rule, the Final Rule attempts to expand and clarify the *bona fide* hedge definition. First, the *bona fide* hedging transactions specifically enumerated in the Final Rule now include certain anticipated merchandising transactions, royalties and service contracts to reflect concerns by commercial firms. Second, the Final Rule includes an appendix which lists transactions and fact patterns that the CFTC deems to qualify for the *bona fide* hedge exemption. Third, the Final Rule provides exemptions for pass-through swaps, pass-through swap offsets and financial distress circumstances. Fourth, the Final Rule permits market participants to petition the CFTC for exemptive relief for any legitimate risk reducing hedging transaction to qualify as a *bona fide* hedging transaction, or to seek interpretive guidance from CFTC staff on whether their hedging strategies qualify as a *bona fide* hedge. The Final Rule does not contain a risk management exemption, as proposed by several comment letters. The CFTC's view is that the underlying concern is addressed by the ability of entities to net referenced contracts in the same portfolio for purposes of calculating position limits.

In conjunction with the *bona fide* hedge exemption, the Final Rule establishes reporting requirements. Upon exceeding a position limit, any person relying upon the *bona fide* hedge exemption must file a detailed report within three business days following the day that a position limit is exceeded and thereafter file daily data on a monthly basis. In addition, in order to claim an anticipatory hedge exemption, the Final Rule provides that a trader must make a notice filing 10 days in advance of the date that such transactions or positions will exceed the position limits. The exemption is effective 10 days after such filing; however, the CFTC has the ability to request additional information to support the claimed exemption.

## Aggregation of Positions

The Final Rule largely retains the current aggregation ownership and control standards, the existing independent account controller exemption, and the current pool aggregation standard. A trader will be required to aggregate (i) positions in accounts for which such trader directly or indirectly controls trading, (ii) positions held by such trader and one or more other traders, all acting pursuant to an express or implied agreement or understanding the same as if the positions were held by, or the trading done by, a single trader, (iii) positions in accounts in which any trader, directly or indirectly, has an ownership or equity interest of 10%, and (iv) positions in multiple accounts or pools, including passively managed index funds, if those accounts or pools had identical trading strategies. The new requirement to aggregate interests in funds or accounts with identical trading strategies was adopted in the Final Rule as proposed. The CFTC noted that it interprets the "hold" or "control" criterion as applying separately to ownership of positions and to control of trading decisions.

The Final Rule retains the independent account controller exemption currently relied upon by many market participants, with clarifications which make explicit that the exemption is limited to client positions, that is, only to the extent one trades professionally for others can one avail him or herself of the exemption. The exemption does not, therefore, extend to proprietary accounts which the trader owns. The CFTC noted that it will look to certain factors, including the existence of proper firewalls, in determining whether a trader has independent control over certain positions or accounts for aggregation purposes.

In addition, as is currently the case, positions in pools in which a person that is a limited partner or shareholder and has an equity ownership interest of less than 25% do not need to be aggregated if such person does not have control over or knowledge of the pool's trading. Moreover, positions of a futures commission merchant in certain discretionary accounts do not need to be aggregated if such futures commission merchant maintains only minimum control over trading in the relevant account and if the trading decisions of that account are independent from trading decisions in such futures commission merchant's other accounts.

The Final Rule requires a firm relying on a disaggregation exemption, including the independent account controller exemption, to make a notice and certification filing (setting forth the circumstances that warrant disaggregation) which will be effective on filing and will not require further approval from the CFTC. At the CFTC's request, any person claiming a disaggregation exemption must provide further information concerning the claim for exemption. The CFTC can audit the trader for adequacy of its information barriers and related practices. If the CFTC finds that a trader is not appropriately following the conditions of the exemption, upon notice and an opportunity to respond, the CFTC may amend, suspend, terminate or otherwise modify a person's aggregation exemption.

## Preexisting Positions

The CFTC clarified that a person can rely on the exemption for preexisting positions for futures, options and swaps entered in good faith prior to the effective date of the Final Rule for non-spot month position limits. Such preexisting futures, options and swaps transactions that are in excess of the proposed position limits would not cause the trader to be in violation based solely on those positions. To the extent a trader's preexisting futures, options or swaps positions would cause the trader to exceed the non-spot month limit, the trader could not increase the directional position that caused the positions to exceed the limit until the trader reduced the positions to below the position limit. The CFTC retained the broader exemption for swaps entered prior to the effective date of the Dodd-Frank Act and prior to the initial implementation of the Final Rule. Pre-effective date swaps will not be subject to the position limits of the Final Rule, and traders may, but need not, net swaps entered before the effective date of Dodd-Frank with swaps entered after the effective date.

## Compliance Dates

The compliance date for all spot month limits and non-spot month legacy limits is 60 days after the term "swap" is further defined (which is expected to be prior to mid-July 2012). Prior to the CFTC further defining the term "swap", market participants will continue to comply with the existing position limits regime. After the compliance date, the CFTC will revoke the current position limit rules and persons will be required to comply with all provisions of the Final Rule, including the provisions for *bona fide* hedging and the aggregation of accounts. For non-spot month non-legacy referenced contracts, the compliance date will be set forth by CFTC order establishing such limits approximately 12 months after the collection of swap positional data.

For further information, please contact [Deborah Monson](#) or the Ropes & Gray attorney with whom you usually work.