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CFTC Reproposes Rules on Position Limits for Futures and Swaps

Overview

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The U.S. Commodity Futures Trading Commission (the "Commission") recently extended the comment period on its latest proposal to expand its speculative position limit rules (the "Proposed Rules" or the "Proposal"). The Proposed Rules would establish new and amended spot month speculative position limits for certain physical and cash-settled commodity futures and options contracts and economically equivalent swaps. In addition, the Proposed Rules would revise certain exemptions from speculative position limits, including for bona fide hedges, and add or amend certain definitions. The Commission is now seeking comment on the Proposed Rules until May 15, 2020. Adopting new position limit rules has been a priority for the Commission, and we expect that final rules will be enacted before the end of the year. Asset managers and other market participants should analyze the Proposal's impact to determine whether to submit a comment letter to the Commission, as well as to prepare for the changes.

Contracts Subject to the Proposed Position Limits

Speculative position limits are limits on the maximum positions (net long or net short) in certain commodity derivative contracts that a market participant can own or control in the aggregate. These limits apply intraday and it is a violation to exceed them without having obtained an exemption. Federal speculative position limits currently apply to futures and options on futures on only nine physically settled agricultural contracts,[1] with the exchanges setting any position limits on other contracts. Speculative position limits apply separately to positions in the spot month[2] and in non-spot months.

The Proposed Rules would expand the number of physically settled contracts covered, as well as extend to cover linked cash-settled futures and economically equivalent swaps. More specifically, under the Proposed Rules, federal speculative limits would apply to (i) 25 physically settled futures and options contracts ("core referenced futures contracts"),[3] (ii) cash-settled futures and options contracts that are directly or indirectly linked to either the price of a core referenced futures contract or to the same commodity underlying the core referenced futures contract for delivery to the same location specified in that contract and (iii) economically equivalent swaps (collectively, "referenced contracts"). A swap is considered economically equivalent if its material specifications, terms and conditions are identical to the core referenced futures contract or to the linked cash-settled futures contract. Material provisions would include the underlying commodity, including commodity reference price and grade differentials, maturity or termination dates, and settlement type (physical or cash-settled). Differences in (i) lot size or notional amount, (ii) delivery dates diverging by less than one calendar day on physically-settled swaps (or less than two calendar days for natural gas swaps), or (iii) post-trade risk management arrangements are not considered material for this purpose, so a swap with only those differences would still be economically

[1] The nine legacy agricultural commodities contracts are Chicago Board of Trade Corn, Oats, Soybeans, Wheat, Soybean Oil, Soybean Meal, KC Hard Red Winter Wheat, ICE Cotton No. 2, and Minneapolis Grain Exchange Hard Red Spring Wheat.

[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 25 core referenced futures contracts are Chicago Board of Trade Corn, Oats, Rough Rice, Soybeans, Soybean Meal, Soybean Oil, Wheat and KC Hard Red Winter Wheat; Chicago Mercantile Exchange Live Cattle; Commodity Exchange, Inc. Gold, Silver and Copper; ICE Cocoa, Coffee C, FCOJ-A, Cotton No. 2, U.S. Sugar No. 11 and U.S. Sugar No. 16; Minneapolis Grain Exchange Hard Red Spring Wheat; and New York Mercantile Exchange Palladium, Platinum, Light Sweet Crude Oil, New York Harbor ULSD Heating Oil, New York Harbor RBOB Gasoline and Henry Hub Natural Gas. Note that the Commission may expand the list of core referenced futures contracts in physical commodities in the future.

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equivalent. In contrast, a swap would not be economically equivalent if it is cash-settled and the core referenced futures contract is physically delivered. This may put many swaps out of scope for federal position limits.

Spot Month Position Limits

Under the Proposed Rules, federal spot month position limits would apply to all referenced contracts. There would be a position limit for physically settled referenced contracts and also a limit for cash-settled referenced contracts, which would be set at or below 25 percent of deliverable supply. Deliverable supply would be estimated using recent data provided by the DCMs, verified by the Commission, and would apply on a futures-equivalent basis. Notably, spot month position limits would be applied separately for physically settled referenced contracts and for cash-settled referenced contracts. This means that, although market participants would be permitted to net positions across physically settled referenced contracts and to net positions across cash-settled referenced contracts, they would not be able to net across physically settled and cash-settled referenced contracts.

Non-Spot Month Position Limits

Under the Proposed Rules, only the core referenced futures contracts based on the nine legacy agricultural commodities would be subject to federal limits outside the spot month. The proposed non-spot month limits for these contracts would apply to physical delivery and cash-settled contracts together so they can be netted. Outside of the spot month, non-legacy core referenced futures contracts would be subject to exchange-set limits, but not federal limits. The proposed non-spot month limit levels would be set at 10 percent of open interest for the first 50,000 contracts. An incremental increase of 2.5 percent of open interest would apply thereafter on a futures-equivalent basis, based on the size of the unit of trading of the relevant core referenced futures contract.

Pre-existing Positions

Certain positions entered into prior to the effective date of final position limit rules ("Pre-Existing Positions") would not be subject to Commission limits. Swaps with unexpired terms that were entered into prior to the Dodd-Frank Act ("Pre-Enactment Swaps") and swaps entered into between July 22, 2010 and 60 days after the publication of final position limit rules ("Transition Period Swaps") also would not be subject to Commission limits. All other Pre-Existing Positions acquired in good faith before the effective date of final position limit rules would be subject to federal position limits during the spot month only.

Position Limit Exemptions

Consistent with current practice, the proposed amendments to Part 150 would maintain exemptions from speculative limits for certain positions, including for bona fide hedging transactions. In addition, the Proposed Rules would retain and expand the exemption for spread transactions and create a (i) new exemption for persons who acquire positions from a market participant in financial distress and (ii) conditional exemption for certain natural gas positions.

The Proposed Rules revise and add to the current general definition of "bona fide hedging transactions or positions." Under the current definition, for a position in a physical commodity derivative to be considered a bona fide hedge, the position must (i) *normally* represent a substitute for a transaction made at a later time in a physical marketing channel (emphasis added) (the "temporary substitute test"); (ii) be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise (the "economically appropriate test"); (iii) arise from the potential change in the value of actual or anticipated assets, liabilities or services; (iv) have a purpose to offset price risks incidental to commercial cash or spot operations (the "incidental test"); and (v) be both established and liquidated in an orderly manner (the "orderly trading requirement").

The Proposed Rules would modify the temporary substitute test to require that transactions must *always* be connected to the production, sale, or use of a physical cash-market commodity in order to qualify as bona fide hedges. The Commission

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interprets this change to eliminate the recognition of risk management positions as bona fide hedges. Further, the Proposed Rules (i) clarify that for purposes of the economically appropriate test, "risk" refers to "price risk" and (ii) would formally eliminate the incidental test and the orderly trading requirement.

Under the Proposed Rules, the current list of enumerated hedging transactions based on the core referenced futures contracts would be expanded and relocated from Rule 1.3 to a new Appendix A to Part 150.[4] Such enumerated exemptions would be self-effectuating for Commission purposes, and a person holding an enumerated bone fide hedging position based on one of the core referenced futures contracts would not need to request prior approval from the Commission before exceeding the relevant federal position limit. Further, transactions that fall outside the enumerated examples but comply with the bona fide hedging definition, as modified by the Proposed Rules, could be recognized as bona fide hedges upon application to the Commission or the relevant exchange through a process outlined in the Proposed Rules and further detailed below.

The Proposed Rules clarify that, in certain circumstances, market participants may measure risk on a gross, as opposed to net, basis. The Proposed Rules would permit hedging on a gross basis so long as a participant has hedged on a gross basis over time and in a consistent manner (and not in order to evade federal limits).

In addition, the Proposed Rules would eliminate the federal five-day rule, under which certain enumerated hedging positions in contracts for physical delivery are not recognized as bona fide hedges when the positions are held during the last five trading days in the spot month. Instead, under the proposal, exchanges would have discretion to apply or waive a five-day rule or alternative restriction with respect to the exchanges' own position limits.

Moreover, the Commission proposes (i) to continue the exemption for spread transactions,[5] (ii) a new exemption for positions acquired from persons in financial distress circumstances, and (iii) a conditional exemption from spot month position limits in natural gas.

Spread exemptions, like enumerated bona fide hedging transactions or positions, would be self-effectuating for Commission position limit purposes so long as they fall within the proposed definition of "spread transaction," and the market participant separately applies for an exemption from exchange-set limits. Spread positions falling outside the proposed definition would be subject to approval upon application to the Commission and separate application to the exchange. 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.

The proposed financial distress exemption would allow a market participant to exceed federal limits if necessary to take on the positions and associated risk of another market participant that is in a potential default or bankruptcy situation. This exemption would be available on a case-by-case basis.

Further, the Proposed Rules would provide an exemption from the proposed spot month position limit on natural gas. A grant of such an exemption would be conditioned on the participant not holding or controlling any positions during the spot month in the physically-settled NYMEX NG core referenced futures contract. Market participants seeking to exceed the proposed spot month limit could receive an exemption of five times the limit per exchange, plus an additional five times the limit in economically equivalent swaps.

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[4] The following are the enumerated bona fide hedging transactions under the Proposal: (1) hedges of inventory and cash-commodity fixed-price purchase contracts; (2) hedges of unsold anticipated production; (3) hedges of cash commodity fixed-price sales contracts; (4) certain cross-commodity hedges; (5) hedges of unfilled anticipated requirements; (6) hedges of offsetting unfixed price cash commodity sales and purchases; (7) hedges by agents; (8) hedges of anticipated royalties; (9) hedges of services; (10) offsets of commodity trade options; and (11) hedges of anticipated merchandising. Notably, the first six enumerated transactions are currently set forth in Rule 1.3 and, except for being moved to Appendix A to Part 150, would remain unchanged under the Proposal.

[5] Transactions or positions qualifying as "spread transactions" include the following common types of spreads: calendar spreads, intercommodity spreads, quality differential spreads, processing spreads, product or by-product differential spreads, or futures-option spreads.

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Reporting and Recordkeeping Requirements

The Proposal would make changes to the Commission's reporting rules. Under the Proposed Rules, a position that meets one of the enumerated categories of bona fide hedges would automatically be recognized as an exempt bona fide hedge for purposes of Commission limits. A market participant would still need to apply to the relevant exchange for an exemption from exchange-set limits on the position. Because Form 204/304 filings would no longer be required, the Commission would instead gather cash market information from a participant's application to an exchange for exemptions from exchange-set limits. A participant seeking bona fide hedging recognition for a transaction not enumerated in new Appendix A would apply directly to the relevant exchange for purposes of both federal and exchange-set limits. Upon a determination by the exchange that the position is a bona fide hedge, the market participant would be permitted to rely on the exchange's determination for ten business days pending Commission evaluation. Market participants would be required to request approval prior to taking a position exceeding federal limits except in the case of sudden or unforeseen hedging needs.

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. Exchange-set spot month limits on physical commodity contracts not subject to federal limits generally could not exceed 25 percent of deliverable supply. However, the Proposal would permit DCMs and SEFs to submit alternative limit levels to the Commission for review, provided the alternative limits are deemed "necessary and appropriate to reduce the potential threat of market manipulation or price distortion of the contract's or the underlying commodity's price or index."

Outside of the spot month, exchanges would have broad discretion to formulate either position limits or accountability levels on futures and options on futures. The exchanges would continue to have flexibility in granting exemptions, but would be required to consider whether the exemption would run afoul of "sound commercial practices" or "exceed an amount that may be established and liquidated in an orderly fashion" in a particular market.

Exchange-set limits and exemptions would remain subject to the Commission's review. The Commission intends to delay the implementation of exchange-set position limits on swaps. As a result, Proposed Rule 150.5 would affect only futures and options on futures traded on exchanges until the Commission determines that exchanges have access to sufficient data to monitor compliance with position limits on swaps across exchanges.

Aggregation

Commission rules require aggregation of positions that a market participant owns or controls for purposes of determining compliance with position limits, with certain exceptions. The federal aggregation rules currently apply to the nine legacy agricultural contracts. Upon adoption of final position limit rules, the aggregation rules would apply as well to the contracts newly subject to the federal limits. At the exchange level, there would be parallel aggregation rules for contracts not subject to federal limits.

Compliance date

The Proposal provides for a one-year transition period, so that the compliance date would be one year after the final rules are published in the Federal Register.

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Please contact Deborah A. Monson, Jeremy A. Liabo, Erin F. Conklin, Elyssa Westby or the Ropes & Gray attorney who normally advises you with any questions you may have or if you would like additional information.

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