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CFTC Finalizes Revised Rules on Position Limits for Futures and Swaps

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Overview

In a three-to-two vote on October 15, 2020, the U.S. Commodity Futures Trading Commission (the "**CFTC**") finalized revised speculative position limit rules (the "**Final Rule**"), wrapping up a ten-year endeavor. The Final Rule establishes 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 Final Rule revises certain exemptions from speculative position limits, including for bona fide hedges, and adds new exemptions. Asset managers and other market participants should analyze the Final Rule's impact to determine whether the revised limits will affect their hedging and trading activities and whether they will be required to aggregate commodity derivative positions with accounts, investment vehicles or other entities under their ownership or control, which might include portfolio companies.

Contracts Subject to Position Limits

Speculative position limits are the maximum positions (net long or net short) in certain commodity derivative contracts that a market participant may own or control in the aggregate. The CFTC and the exchanges establish position limits in an effort to prevent burdens associated with excessive speculation causing sudden or unreasonable fluctuations, as well as unwarranted changes in the price of an underlying commodity (such as food and energy prices). These limits apply intraday, and market participants may not exceed them without qualifying for an exemption. Federal speculative position limits have historically applied to futures and options on futures on only nine physically settled agricultural contracts (the "**nine legacy agricultural contracts**"),[1] with the exchanges setting any position limits on other contracts. The Final Rule establishes position limits for an additional 16 physically settled futures and options contracts (the "**non-legacy contracts,**" and together with the nine legacy agricultural contracts, the "**core referenced futures contracts**").[2] Under the Final Rule, federal speculative limits will be applicable to (i) the 25 core referenced futures contracts, (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 ("**cash-settled referenced contracts**") and (iii) economically equivalent swaps (collectively, "**referenced contracts**"). Position limits outside the spot month apply only to the nine legacy agricultural contracts and their related cash-settled referenced contracts. In addition, the Final Rule raises federal position limits on the nine legacy agricultural contracts (except for CBOT Oats, which remains the same).

A swap is considered economically equivalent if its material specifications, terms and conditions are identical to the core referenced futures contract or to the cash-settled referenced contract. Material provisions include the underlying commodity, 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. In addition, many documentation terms that are

[1] The nine legacy agricultural 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] The 25 commodities underlying the core referenced futures contracts are CBOT: Corn, Oats, Rough Rice, Soybeans, Soybean Meal, Soybean Oil, Wheat and KC Hard Red Winter Wheat; CME: Live Cattle, 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 NYMEX: Palladium, Platinum, Light Sweet Crude Oil (also known as WTI), New York Harbor ULSD Heating Oil, New York Harbor RBOB Gasoline and Henry Hub Natural Gas. Note the CFTC may, in the future, expand the list of core referenced futures contracts to include additional commodities, such as NYMEX WTI Houston and ICE Canola.

unique to swaps (as opposed to futures), such as contractual terms, provisions and definitions, whether standardized or bespoke, generally will not be considered material by the CFTC. The CFTC declined to publish a list of economically equivalent swaps. However, the CFTC will not bring an enforcement action against a market participant who violates federal position limits as long as the market participant (i) performed the necessary due diligence and is able to provide sufficient evidence, if requested, to support its reasonable, good faith determination that the swap is not an economically equivalent swap and (ii) comes into compliance with the applicable federal position limits within a commercially reasonable time.

Spot Month Position Limits

The Final Rule extends federal spot month position limits to all referenced contracts, imposing position limits for physically settled referenced contracts and separately for cash-settled referenced contracts, which would be set at or below 25 percent of deliverable supply, estimating deliverable supply using recent data provided by the exchange listing the core referenced futures contract and verified by the CFTC. Market participants are permitted to net spot month positions across physically settled referenced contracts and separately net positions across cash-settled referenced contracts; they are not permitted to net across physically settled and cash-settled referenced contracts. With the exception of natural gas, the spot month levels apply to referenced contracts in the aggregate across exchanges, including, in most instances, foreign boards of trade, and the over-the-counter swap markets.

Non-Spot Month Position Limits

The non-spot month limit levels are set at 10 percent of open interest for the first 50,000 contracts. An incremental increase of 2.5 percent of open interest applies thereafter on a futures equivalent basis, based on the size of the unit of trading of the relevant core referenced futures contract.

Federal non-spot month limits apply only to the nine legacy agricultural contracts and their cash-settled referenced contracts. Physically settled and cash-settled contracts may be netted outside of the spot month. Non-legacy contracts and their related cash-settled referenced contracts are only subject to exchange-set limits.

Relief for Pre-existing Positions

Certain positions entered into prior to the effective date of the Final Rule (“**pre-existing positions**”) are not subject to CFTC limits. Swaps with unexpired terms that were entered into prior to the Dodd-Frank Act and swaps entered into between July 22, 2010 and before the effective date of the Final Rule are not subject to CFTC’s position limits. All other pre-existing positions acquired in good faith before the effective date of the Final Rule are subject to federal position limits during the spot month only.

Aggregation

CFTC rules require aggregation of positions that a market participant owns or controls for purposes of determining compliance with position limits, with certain exceptions. The Final Rule expands the scope of contracts to which the aggregation rules apply. Asset managers should therefore determine whether any accounts, investment vehicles or other entities under their ownership or control, which might include portfolio companies, utilize any contracts that are now subject to federal position limits and, if so, whether they are required to aggregate such positions under the CFTC’s rules. Discussions of the CFTC’s position limit aggregation rules and exemptions from the aggregation requirement are available here and here.

Position Limit Exemptions

Consistent with current practice, the Final Rule maintains exemptions from position limits for certain positions, including for bona fide hedging transactions and spread transactions, with significant revisions. In addition, the Final Rule includes exemptions from position limits for certain positions (i) acquired by market participants in financial distress and (ii) in natural gas contracts. All persons who avail themselves of an exemption from position limits under the Final Rule will have to comply with additional recordkeeping requirements and will be subject to periodic calls by the CFTC.

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Bona Fide Hedging Transactions or Positions

The Final Rule revises the current exemption from position limits for "bona fide hedging transactions or positions."[3] The elements of the bona fide hedge exemption are that the position (i) represents a substitute for transactions made at a later time in a physical marketing channel (the "**temporary substitute test**"); (ii) is economically appropriate to the reduction of price risks in the conduct and management of a commercial enterprise (the "**economically appropriate test**"); and (iii) arises from a potential change in the value of actual or anticipated assets, liabilities or services (the "**change in value requirement**"). In order to satisfy the temporary substitute test, transactions are required to *always*, and not just *normally* (as was previously the case), be connected to the production, sale, or use of a physical cash-market commodity. This change excludes risk management positions from being recognized as bona fide hedges.

The CFTC has also clarified that for purposes of the economically appropriate test, "risk" refers to "price risk". The Final Rule eliminates the incidental test and the orderly trading requirement, both of which were previously part of the bona fide hedge exemption.

The Final Rule also expands the scope of transactions that qualify for the bona fide hedging exemption to include "pass-through swaps" and "pass-through swap offsets." A pass-through swap is a swap entered into by one party for which the swap qualifies as a bona fide hedging transaction and another party for which the swap is not a bona fide hedging transaction (the "pass-through swap counterparty"). A pass-through swap offset (i) is a futures contract, option on a futures contract or swap position entered into by a pass-through swap counterparty and (ii) reduces the pass-through swap counterparty's price risks attendant to the pass-through swap. In order for a pass-through swap counterparty to be able to treat a pass-through swap offset as a bona fide hedge, the pass-through swap counterparty must receive a written representation from the bona fide hedging swap counterparty that the pass-through swap qualifies as a bona fide hedge for the bona fide hedging swap counterparty. The pass-through swap counterparty may rely in good faith on such written representation, unless the pass-through swap counterparty has information that would cause a reasonable person to question the accuracy of the representation.

In addition, the Final Rule will eliminate Forms 204 and 304, which are currently required to filed by market participants who hold bona fide hedging positions in excess of federal limits. Market participants will instead be required to provide certain cash market information to the exchanges, which the CFTC may obtain upon request.

The Final Rule also clarifies that, in certain circumstances, market participants may measure risk on a gross, as opposed to net, basis for both enumerated and non-enumerated bona fide hedges. It permits 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 an effort to evade federal limits). The Final Rule does not require that exchanges document their justifications when allowing gross hedging, nor does it require market participants to develop written policies and procedures addressing when gross hedging versus net hedging is appropriate. Market participants may, however, wish to establish such policies or procedures to demonstrate compliance.

Enumerated Bona Fide Hedging Transactions

[3] Before the adoption of the Final Rule, in order for a position to be deemed a bona fide hedge for federal position limits, purposes, the position must satisfy five key elements. Specifically, the position must (i) normally represents a substitute for a transaction made at a later time in a physical marketing channel; (ii) meets the economically appropriate test; (iii) arises from the potential change in the value of actual or anticipated assets, liabilities or services; (iv) has a purpose to offset price risks incidental to commercial cash or spot operations (the "incidental test"); and (v) is both established and liquidated in an orderly manner (the "orderly trading requirement").

The Final Rule significantly expands the scope of transactions that qualify for an enumerated bona fide hedging exemption.[4] The enumerated exemptions, which are set forth in Appendix A of Part 150, are self-effectuating for purposes of federal limits, but not for exchange limits. Consequently, a person relying on an enumerated bona fide hedging exemption will not need to request prior approval from the CFTC before exceeding the relevant federal position limit but will need to request an exemption from an exchange before exceeding the relevant exchange-set limits.

Non-Enumerated Bona Fide Hedging

A market participant seeking bona fide hedging recognition for a transaction not enumerated in new Appendix A may 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 CFTC evaluation. During this period the applicant may exceed the limit at its own risk. If the CFTC disagrees with the exchange's determination to grant an application to exceed a federal position limit, the CFTC will not pursue enforcement provided the application to exceed the position limit was made in good faith and the market participant unwinds the position in a commercially reasonable amount of time. The Final Rule also allows a market participant with sudden or unforeseen hedging needs to file a request for a bona fide hedge exemption within five business days after exceeding a federal limit, and if the CFTC denies the request, the overage will not constitute a position limit violation if the application was filed in good faith and the position is brought into compliance within a commercially reasonable amount of time. Otherwise, market participants are required to request approval in advance.

Spread Exemption

The Final Rule amends the process for obtaining a spread exemption ("**spread exemption**"). For transactions that fall within the definition of "spread transaction,"[5] the spread exemption from federal limits is self-effectuating, as is currently the case, provided that the market participant separately applies for an exemption from exchange-set limits. Spread positions falling outside the spread transaction definition are subject to approval upon both an application to the CFTC and a separate application to the applicable exchange.

New Exemptions to Position Limits

The Final Rule exempts from federal limits certain positions acquired by persons in financial distress circumstances (the "**financial distress exemption**") and provides a conditional exemption from spot month position limits in natural gas.

The new financial distress exemption allows 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 is available on a case-by-case basis.

Further, the Final Rule provides a new exemption from the spot month position limit on natural gas. A grant of such an exemption will be conditioned on the participant neither holding nor controlling any positions during the spot month in physically settled NYMEX NG core referenced futures contracts. Pursuant to the exemption, a market participant may exceed the limit on NYMEX NG cash-settled referenced contracts and cash-settled economically equivalent NYMEX

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[4] The following are the enumerated bona fide hedging transactions under the Final Rule: (1) hedges of inventory and cash-commodity fixed-price purchase contracts; (2) hedges of cash commodity fixed-price sales contracts; (3) hedges of offsetting unfixed price cash commodity sales and purchases; (4) hedges of unsold anticipated production; (5) hedges of unfilled anticipated requirements; (6) hedges of anticipated merchandising; (7) hedges by agents; (8) short hedges of anticipated mineral royalties; (9) hedges of anticipated services; (10) offsets of commodity trade options; and (11) cross-commodity hedges.

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

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NG swaps. Market participants seeking to exceed the 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.

Elimination of Exemptions

The Final Rule eliminates 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, exchanges are granted discretion to apply or waive a five-day rule or alternative restriction with respect to the exchanges' own position limits.[6]

Exchange-Set Position Limits

Under the Final Rule, futures exchanges and swap execution facilities are required to adopt position limits on all referenced contracts that are no higher than the federal limit. However, the CFTC has delayed exchange-set limits on swaps because exchanges cannot view market participants' swap positions across the various places they trade. In two years, the CFTC will re-evaluate the eligibility of exchanges to establish and implement appropriate surveillance mechanisms. Exchanges are also required, under the Final Rule, to establish position limits and accountability levels in the non-spot months for the non-legacy core referenced futures contracts and related cash-settled referenced contracts.

Compliance Date

The Final Rule will come into effect 60 days after publication in the Federal Register; however, market participants will be required to comply with only certain portions of the Final Rule on that date. The tiered compliance dates provided in the Final Rule are as follows:

- The new position limits in respect of the nine legacy agricultural contracts and the new bona fide hedge exemptions will take effect 60 days after the publication of the Final Rule in the Federal Register;

- The position limits in respect of non-legacy core referenced futures contracts and their cash-settled referenced contracts will take effect on January 1, 2022; and

- The federal position limits for economically equivalent swaps and the deadline for market participants to discontinue reliance on previously granted risk management exemptions will take effect on January 1, 2023.

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

[6] The Final Rule also eliminates the "twelve-month restriction" in regards to an anticipatory unsold production and the anticipated unfilled requirements bona fide hedges, under which market participants were restricted from using such bona fide hedges for unsold anticipated production or unfilled anticipated requirements in order to hedge more than twelve-months' unsold production and/or unfilled requirements. However, the anticipated merchandising bona fide hedge will be subject to a twelve-month restriction.

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