SULLIVAN & CROMWELL LLP

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CFTC Proposed Rules on Position Limits on Physical Commodity Derivatives

CFTC Adopts Proposed Rule during Public Meeting to Impose Position Limits on Futures and Swaps on Physical Commodities

SUMMARY

On January 13, 2011, the Commodity Futures Trading Commission (the "Commission" or the "CFTC") held its 9th public meeting in its Dodd-Frank Wall Street Reform Act ("Dodd-Frank") rulemaking process, during which it voted 4-1 to approve the publication of proposed rules to impose position limits on 28 commodity futures and option contracts on exempt and agricultural commodities, and on "economically equivalent" swaps (the "Proposed Rule"). The CFTC had considered the Proposed Rule at its December 16, 2010 open meeting but CFTC Chairman Gary Gensler adjourned that meeting without holding a vote on the Proposed Rule. The Proposed Rule would, if adopted, enact position limits first on positions in the spot month and subsequently on positions in other months. It would also establish different limits for physically and cash settled derivatives, and would provide for hedge exemptions for physical commodity hedging and aggregation of positions under common ownership or control. The Proposed Rule will be published in the Federal Register for a 60 day comment period.

BACKGROUND

Under the new regulatory regime established by Dodd-Frank, the CFTC was given authority to impose spot-month, single-month, and all-month combined position limits on derivatives on physical commodities. In setting these limits, the CFTC is directed to establish position limits not only on listed futures and options, but also on swaps that are "economically equivalent" to futures or options contracts on physical commodities. In addition, Dodd-Frank requires the CFTC to establish aggregate position limits, including for any "group or class of trader" for contracts based on the same underlying commodity across exchanges, swap execution facilities, foreign boards of trade, and over-the-counter ("OTC") swaps that perform a significant price discovery function. Dodd-Frank provides that the limits on exempt commodities (energy and metals commodities), must be imposed by January 2011, and on agricultural commodities, the limits must be imposed by April 2011. The first of these deadlines, and apparently the second as well, will not be met.

Dodd-Frank also gives the CFTC authority to grant hedge exemptions to parties entering into bona fide hedging transactions, which are narrowly defined as physical hedging transactions that are economically appropriate for the reduction of risks of a commercial enterprise. A counterparty to a bona fide hedger will also be eligible for the bona fide hedging exemption for transactions it enters into (including futures) to offset transactions it enters into with bona fide hedgers.

The Proposed Rules follow actions proposed by the CFTC and Congress during the past several years to address concerns over what some have characterized as "excessive speculation" and "excess volatility" in the energy markets, as well as in other physical commodity markets. In July and August 2009, the CFTC held a series of hearings on the issue of whether the CFTC itself should impose speculative position limits on energy commodities and other commodities for the purpose of preventing "excessive speculation." In January 2010, the CFTC proposed a rule to impose directly speculative position limits on futures and option contracts on specified energy commodities (rather than allowing such limits to be set by the exchanges, as had previously been the case). Due to the broadened scope of CFTC authority to set position limits following the enactment of Dodd-Frank, the CFTC withdrew the proposed position limits on energy commodities in August 2010.

On November 2, 2010, the CFTC proposed position reporting requirements for swaps which are economically equivalent to commodity futures and options contracts traded on or subject to designated contract markets ("DCMs"). The CFTC believes that the data generated from such reporting requirements are "reasonably necessary for implementing and enforcing aggregate position limits for certain physical commodity derivatives." The absence of data on the OTC markets has motivated the CFTC to propose a two-phased position limit regime, as discussed below.

VIEW OF THE COMMISSIONERS

While the Commission voted 4-1 to publish the Proposed Rule for comment, three of the Commissioners (including Commissioner Jill Sommers dissenting) expressed serious reservations about the Proposed Rule. Commissioner Michael Dunn, who is a Democrat but is generally considered the "swing vote", supports the Proposed Rules "in order to gather more information." In an unusually strong statement, Commissioner Dunn stated:

> To date, CFTC staff has been unable to find any reliable economic analysis to support either the contention that excessive speculation is affecting the markets [the CFTC] regulate[s] or that position limits will prevent excessive speculation. The task then is for the CFTC staff to determine whether position limits are appropriate. With such a lack of

> concrete economic evidence, my fear is that, at best, position limits are a cure for a disease that does not exist or at worst, a placebo for one that does.
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> I am voting for the proposed rule on position limits in order to gather more information. If there is more than anecdotal evidence that there is excessive speculation distorting the prices in our markets, we need to see it…. If we determine that position limits are appropriate to diminish, eliminate or prevent excessive speculation, I think we must then work with our sister regulators around the globe to ensure that limits set here in US markets, are not simply evaded by trading in other venues around the world.

Commissioner Scott O'Malia also expressed skepticism about the Propose Rules and supports their publication to gather public comments. Without appropriate data he indicated he was concerned that the Commission could not set position limits at appropriate levels. Commissioner Sommers in dissent argued that the position limits should be postponed until the Commission collects the necessary data. She suggested that the Commission take advantage of the discretion given by Congress to set different limits for different classes of traders. She also expressed concern that position limits could "shift price discovery outside of the US."

The concerns expressed by the three Commissioners raise serious questions about whether the Proposed Rules will be finalized, at least in their current form.

THE PROPOSED RULES

Commodities Covered

The Proposed Rules would impose position limits on 28 exempt and agricultural commodity futures and option contracts (the "core referenced futures contracts") and their "economically equivalent" swap contracts (together, the "referenced contracts"). The covered exempt (i.e., non-agricultural physical) commodities are copper, gold, palladium, platinum, silver, light sweet crude oil, gasoline, natural gas, and heating oil. The covered agricultural contracts are cocoa, coffee, corn, cotton no. 2, feeder cattle, frozen concentrated orange juice, lean hogs, live cattle, class III milk, oats, rough rice, soybeans, soybeans, soybean meal, soybean oil, sugar no. 11, sugar no. 16, CBOT wheat, hard red spring wheat, and hard winter wheat.

A swap would be considered "economically equivalent" to a futures contract under the Proposed Rule if it is either:

- directly or indirectly linked, including being partially or fully settled against, or priced at a differential to, the price of any core referenced futures contracts; or
- directly or indirectly linked, including being partially or fully settled against, or priced at a differential to, the price of the same commodity for delivery at the same location, or at locations with substantially the same supply and demand fundamentals, as that of any core referenced futures contracts.

Implementation Timing

The Proposed Rules would establish position limits in two phases. In the first phase, the CFTC will adopt interim position limits for the referenced contracts in the spot month only. The interim position limits will remain in effect until the second phase limits are adopted pursuant to a Commission order. In the second phase, the CFTC will, in addition to spot month limits, set single-month and all-months-combined limits for each commodity. The second phase limits will be set annually by the CFTC by January 31st of each year. Chairman Gensler indicated that he hoped the second phase would be finalized early next year.

Position Limits

For phase one, the CFTC will set the interim spot-month position limits at an initial level equal to the current spot-month limits for the referenced contracts established by the DCMs or, in the case of certain agricultural commodities, by the CFTC. The specific interim spot-month limits for each referenced contract are published in Appendix A to the Proposed Rule. The second phase limits, which will be based on OTC and other data the CFTC proposes to collect, will be determined as follows:

- ***Spot-month limits***. For physical delivery referenced contracts, the spot-month position limit will be equal to one-quarter of the estimated spot-month deliverable supply of the physical commodity underlying a core referenced futures contract in the same commodity. For cash-settled referenced contracts, the spot-month position limit will be equal to the level established for physical delivery referenced contracts on the same commodity, except that a trader holding positions exclusively in cash-settled contracts will be eligible for a conditional spot-month position limit that is five times the spot-month limit for physical delivery referenced contracts, if the trader (a) does not hold or control positions in cash-settled contracts in the spot month that exceed the level of any single month position limit, (b) does not hold or control any positions in the physical delivery referenced contract based on the same commodity that is in such contract's spot month and (c) does not hold or control cash or forward positions in the referenced contract's spot month in an amount that is greater than one-quarter of the deliverable supply in the referenced contract's underlying commodity deliverable at the location(s) specified for the core referenced contract in the same commodity. The spot-month limits will apply only to positions in physical delivery or cash-settled referenced contracts with delivery locations that match the delivery locations of a core referenced futures contract in the same commodity.
- ***All-months-combined and single-month position limits within a contract class***. The Commission will impose all-months-combined and single-month position limits within each contract class (i.e., listed futures and options are in one class, swaps in a separate class). The limits will be set at an amount equal to 10 percent of the first 25,000 contracts of the average all-months-combined aggregate open interest in the contract, and 2.5 percent of the open interest for any amounts above 25,000 contracts.
- ***Aggregate all-months-combined and single-month position limit across contract classes***. The Commission also will impose aggregate all-months-combined and single-month position limits for the referenced contracts across contract classes (i.e., across futures and swaps). These would be set at 10 percent of the first 25,000 contracts of average all-months-combined aggregated open interests, and 2.5 percent of the open interests thereafter. The aggregate position limits across contract classes are in addition to the position limits within each contract class. That is, a trader can hold positions up to the prescribed limit in each class, provided that the overall aggregate position is within the applicable aggregate limit.
- ***Legacy position limits***. In addition to the above limits, the Commission is considering phase two legacy position limits for nine referenced agricultural contracts. These legacy position limits would retain the all-month-combined and single-month position limits applicable to futures and option contracts for the enumerated agricultural commodities on DCM markets in current regulation 150.2. The single-month limit for these commodities would be set at the same level as the legacy all-month-combined limit, with the elimination of the calendar month spread exemption. The proposed legacy position limits are (1) 22,000 contracts for Chicago Board of Trade ("CBT") corn, (2) 2,000 contracts for CBT oats, (3) 10,000 contracts for CBT soybeans, (4) 6,500 contracts for CBT wheat, (5) 6,500

contracts for CBT soybean oil, (6) 6,500 contracts for CBT soybean meal, (7) 6,500 contracts for Minneapolis Grain Exchange hard red spring wheat, (8) 5,000 contracts for ICE Futures U.S. cotton No. 2, and (9) 6,500 contracts for Kansas City Board of Trade hard winter wheat.

To determine "deliverable supply," each DCM will submit to the Commission annually an estimate of deliverable supply for each physical delivery referenced contract that is subject to a spot-month position limit and listed or executed pursuant to the rules of the DCM, together with a description of the methodology used to arrive at the estimate and any statistical data supporting the estimate. The Commission will use the estimates provided by the DCMs, or its own estimation of deliverable supply as it sees fit.

The Proposed Rules would require that open interest be determined separately for futures and swaps contracts. The all-months futures open interest would, at month end, be the sum of all of a referenced contract's all-months-combined open futures and option contract open interests across all DCMs, and the all-months swaps open interest would, at month end, be the sum of all of a referenced contract's all-months-combined open swaps and swaptions open interest, combining open interest attributed to cleared and uncleared swaps and swaptions, where the uncleared swap open interest is equal to the sum of all swap dealers' net uncleared open swaps and swaptions exposures by counterparty and by single referenced contract month. To calculate aggregate and class all-months-combined and single-month position limits, the average all-months combined aggregate open interest is equal to the sum for a calendar year of the month end all-months open interest divided by twelve.

Bona Fide Hedge Exemption

The Dodd-Frank Act directs the CFTC to apply a new, narrower definition of hedging for purposes of exemptions from position limits. Exemptions from the position limits are available for those traders engaged in bona fide hedging, within the meaning of that term under Dodd-Frank, to the extent that a transaction or position in a referenced contract: (1) 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; (2) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; (3) arises from the potential change in the value of assets that a person owns, produces, manufactures, processes or merchandises (or anticipates owning, producing, manufacturing, processing or merchandising), liabilities that a person owns (or anticipates incurring) or services that a person provides or purchases (or anticipates providing or purchasing); or (4) reduces risks attendant to a position resulting from a swap that was executed opposite a counterparty for which the transaction would qualify as a bona fide hedging transaction in (1), (2), or (3) above or meets the requirements of (1), (2), or (3) above.

However, the Proposed Rule will not provide risk management exemptions to swap dealers that offer risk management services to market participants that seek to hedge financial risk that is not related to a physical market exposure. Unlike the current hedge exemptions, therefore, exemptions from the Proposed Rule will only be available for physical commodity hedging. The CFTC has proposed amendments to Rule 1.3(z), the bona fide hedging definition, to reflect the changes enacted in this regard by Dodd-Frank.

Any trader with a position that exceeds the position limits must file a form with the Commission listing (1) the cash market commodity hedged, the units in which it is measured, and the corresponding referenced contract that is used for hedging the commodity, (2) the number of referenced contracts used for hedging, (3) the entire quantity of the cash market commodity that is being hedged, (4) the entire quantity of open fixed price purchase commitments in the hedged commodity outside of the spot-month of the corresponding referenced contract, (5) the entire quantity of open fixed price purchase commitments in the hedged commodity in the spot month of the corresponding referenced contract, (6) the entire quantity of open fixed price sale commitments in the hedged commodity outside of the spot month of the corresponding reference contract, and (7) the entire quantity of open fixed price sale commitments in the hedged commodity in the spot month of the corresponding referenced contract.

The Commission will provide anticipatory hedge exemptions for those traders wishing to exceed the position limits in order to hedge unsold anticipated commercial production or unfilled anticipated commercial requirements connected to a commodity underlying a referenced contract. Anticipatory hedge exemptions will only be available on application to the Commission.

Aggregation of Positions

The Proposed Rule proposes a new, more limited aggregation regime that will eliminate the independent account controller exemption that has long been relied upon by a variety of market participants. As a result, the position limits will apply to all positions in accounts for which any trader directly or indirectly holds positions or controls trading, and to positions held by two or more traders acting together, whether by express or implied agreement or understanding, as if the positions were held by a single individual. All accounts or positions in which a trader or entity has a 10 percent or greater ownership or equity interest must be aggregated. As described below, exemptions to the aggregation rule are available for certain positions held by futures commission merchants ("FCMs"), commodity pools or independently controlled and managed non-financial entities.

The aggregation of positions will not apply to traders who are limited partners, shareholders or similar participants in pools with an ownership interest of 10 percent or greater in a pooled account if (1) the pool operator has, and enforces, written procedures to preclude the trader from having knowledge of, gaining access to, or receiving data about the positions of the pool, (2) the trader does not have direct, day-to-day supervisory authority or control over the pool's trading decisions, and (3) the pool operator has applied for and received an exemption from the position aggregation rules. This exception to the aggregation rule is not applicable if the limited partner, shareholder or similar pool participant has a greater than 25 percent ownership interest in the commodity pool or if the limited partner, shareholder or similar pool participant is itself a commodity pool operator.

Any trader that holds or controls the trading of positions, including positions in pools, with identical trading strategies must aggregate all such positions.

The position limits will apply to all positions held by an FCM, or its separately organized affiliates, in a discretionary account, or in an account which is part of, participates in, or receives trading advice from a customer trading program of the FCM or any of the officers, partners or employees of such FCM or its separately organized affiliates unless (1) a trader other than the FCM or the affiliate directs trading in the account, (2) the FCM or the affiliate maintains only such minimum control over the trading in such an account as is necessary to fulfill its duty to supervise diligently trading in the account, (3) each trading decision of the discretionary account or customer trading program is determined independently of all trading decisions in other accounts which the FCM or affiliate holds, has a 10 percent or more financial interest or control, and (4) the FCM has applied with and received an exemption from aggregation from the Commission.

Lastly, entities need not aggregate their positions with those of their 10 percent or more commonly owned non-financial entities if they can sufficiently demonstrate, in an application to the Commission, that the owned non-financial entity's trading is independently controlled or managed. Similar relief is not provided to financial entities.

The Proposed Rule represents a significant change in the CFTC's existing aggregation policy, pursuant to which many financial institutions have relied upon the independent account controller exemption to claim separate position limits and hedge exemptions for affiliates or business units under separate control. Under the Proposed Rules, all such entities and business units would be required to be aggregated, with the exception of those that satisfy the requirements for the non-financial entity exemption.

Netting

For referenced contracts in the spot-month, a trader's positions in physically-settled and cash-settled contracts are calculated separately and traders can hold positions up to the spot-month position limit in each of the physically delivered and cash-settled contract, unless the cash-settled contract positions are held pursuant to the conditional-spot-month limit described above.

For purposes of applying non-spot-month position limits across contract classes, a trader's positions will be netted and the resulting net position applied towards determining the trader's aggregate single-month and all-months-combined position.

For the purpose of applying non-spot-month limits within a contract class, a trader's positions in contracts of the same class will be netted and the resulting net position shall be applied towards determining the trader's class single-month and all-months-combined position.

Preexisting Positions

The established position limits will not apply to swap positions that were entered into prior to the effective date of any final rule imposing position limits on swaps. Swaps and swaptions entered into prior to the effective date of any final rule may be netted with post-effective date swaps and swaptions, and need not be aggregated with positions in referenced contracts that were entered into after the effective date of any final rule.

Visibility Levels

In addition to the proposed position limits, the Proposed Rule would establish "visibility levels" on the referenced copper, palladium, platinum, gold, silver, light sweet crude oil, New York Harbor gasoline blendstock, Henry Hub natural gas and New York Harbor No. 2 heating oil contracts. Under the visibility level scheme, traders holding or controlling positions in excess of the visibility levels for one of the enumerated contracts are subject to reporting requirements. Upon acquiring a position that reaches or exceeds a visibility level, the trader must submit to the Commission a filing for the position in the referenced contract, separately by futures, options swaps or swaptions that comprise the position. The filing must contain (1) the date on which the trader's position initially reached or exceeded the visibility level, (2) gross long and gross short positions on an all-months-combined basis, (3) if the visibility levels are reached or exceeded in any single month, then the contract month and the trader's gross long and gross short positions in the relevant month, and (4) certifications that the trader does not hold or control uncleared swap positions that are based on substantially the same commodity as that which underlies the referenced contract and that the trader does not hold or control cash market commodity positions, or has anticipated commercial requirements or unsold anticipated commercial production in the same or substantially the same commodity as that which underlies the referenced contract. If the certifications in (4) above cannot be provided, then separate filings are required for such uncleared swap positions, cash market commodity positions, anticipated commercial requirements or unsold anticipated commercial production.

Interim Market Surveillance

At the December 16, 2010 open meeting, Commissioner Bart Chilton proposed a "position points" regime (a term that does not appear anywhere in the statute) that would allow the CFTC staff to monitor positions in the 28 covered contracts and provide the CFTC with authority to require traders with positions in excess of the proposed limits to reduce their positions, prior to the adoption of final position limits. The CFTC did not adopt Commissioner Chilton's proposal; instead, until a final rule on position limits is adopted, the CFTC will monitor whether a trader's net position is in excess of 10 percent of open interests up to the first 25,000 contracts, and 2.5 percent thereafter. If a trader is above these positions, the CFTC will more closely analyze that trader's positions.

Staff will brief Commissioners on those traders who exceed these limits. Although the staff (and the Commission) has the authority to issue a Special Call to obtain additional information from market participants, the CFTC does not have the authority to require traders over the position point limit to reduce their position, absent exercising emergency authority pursuant to Section 8(a)(9) of the Commodity Exchange Act, following a finding that an emergency causing market disruption exists and an affirmative vote by the Commission.

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