CFTC to Impose Position Limits on Derivatives on 28 Physical Commodities

CFTC Issues Final Rules to Impose Position Limits on Physical Commodity Futures, Options, Swaps and Swaptions

SUMMARY

The Commodity Futures Trading Commission ("CFTC") adopted interim and final rules on positions limits applicable to option, futures, swap and swaption contracts related to 28 agricultural, metal and energy commodity contracts (the "Final Rules"). The Final Rules impose position limits on a spot-month basis as well as on an all-month and any-month basis. Exemptions are provided from these limits, including a narrow set for bona fide hedging transactions. The Final Rules also exempt certain preexisting positions. Market participants are required to aggregate their interests in commodity contracts across accounts and positions that they control or own, subject to limited exemptions. In addition, the Final Rules impose position visibility requirements with respect to energy and metal contracts. The Final Rules result in radical changes to the CFTC’s long-established position limit regime by, inter alia, taking over responsibility for position limits from the exchanges, expanding limits to include swaps, narrowing exceptions and expanding aggregation requirements.

ADOPTION PROCESS

On October 18, 2011, the CFTC voted 3-2 to adopt the Final Rules, by an adopting release that spans approximately 300 pages (the “Adopting Release”), based on proposed rules issued in January 2011 (the “Proposed Rules”). As of the time of this memo, the Adopting Release has not yet been published in the Federal Register. The CFTC had received over 15,000 comment letters on the Proposed Rules, and the Final Rules differ from those proposed in a number of significant respects.

At the open meeting to adopt the Final Rules (the “Open Meeting”), Commissioners Sommers and O’Malia voted in opposition. Both commissioners asserted that the Final Rules went too far in reducing
the ability of commercial entities to enter into hedging transactions. Commissioner O’Malia also issued a dissent of approximately 25 pages, which will be published in the Federal Register with the Final Rules, an unusual step that reflects the disagreement within the CFTC.

OPEN MEETING

Although Commissioner Dunn voted in favor of adopting the Final Rules, he noted it was unfortunate that position limits, which he described as a “sideshow”, had taken center stage and diverted scarce agency resources away from rulemakings more fundamental to preventing another financial crisis. Commissioner Dunn outlined several serious criticisms of the Final Rules, before finally stating that he was compelled to vote for the Final Rules because he believed the CFTC was required to do so under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”). However, Commissioner Dunn made the following arguments against the Final Rules:

- No one has proven that excessive speculation exists. Dunn stated, “I am still left with the conclusion that no one has presented to this agency any reliable economic analysis to support either the contention that excessive speculation is affecting the markets we regulate or that position limits will prevent excessive speculation. . . . As I said when we voted on the proposed rule, my fear is that position limits [are], at best, a cure for a disease that does not exist or a placebo for one that does. At worst, position limits may harm the very markets [they are] intending to protect.”
- After position limits are imposed, the prices of heating oil, gasoline, food and other products will not fall.
- While prices will not fall, position limits may make it harder for farmers, producers, and other commercial entities to hedge their risks, because the Final Rules will artificially limit market participation, and may send producers inaccurate market signals, resulting in inaccurate production decisions. As a result, position limits may lead to higher prices and increased price volatility.

Before voting in favor of the Final Rules, Commissioner Dunn engaged in a colloquy with Chairman Gensler to, in Commissioner Dunn’s words, “provide me with some assurances that will make me comfortable of the final vote” on the Final Rules and to address his concerns over their impact. During the colloquy, Chairman Gensler agreed to:

- Work “as expeditiously as possible” with the Commissioners, the exchanges and market participants to correct any problems, if the CFTC discovers that the Final Rules are a cause of a major market disruption or have an unintended consequence that must be addressed;
- Actively monitor the impact of position limits and conduct a study on their effects within 12 months after limits are imposed, as required under the Dodd-Frank Act;
- Have the staff clarify issues or provide guidance or relief to commercial end-users if they are experiencing any difficulties with position limits.

Commissioner Sommers remarked that the Final Rules could damage the CFTC’s credibility because when position limits fail to lower commodity prices, the CFTC will ultimately be blamed by those who erroneously believe that position limits can control prices. Commissioner Sommers noted that she does
CFTC to Impose Position Limits on Derivatives on 28 Physical Commodities

November 7, 2011

“not believe position limits will control prices or market volatility.” Commissioner Sommers also raised concerns that the Final Rules will raise the costs of bona fide hedgers, given the elimination of a longstanding provision that allows the CFTC to recognize non-enumerated hedge transactions and by narrowing of the definition of what constitutes a bona fide hedge.

Commissioner O’Malia also pointed out that although the Final Rules are supposed to address “excessive speculation,” the CFTC has no working definition for the term “excessive speculation.” Upon questioning by Commissioner O’Malia, the CFTC General Counsel admitted that the CFTC had set the position limits in the Final Rules based on its best judgment of what levels were necessary to prevent excessive speculation. Further, O’Malia noted that the formulas for setting the limits were not based on a finding of excessive speculation, but were instead based on historical formulas used in the agricultural markets.

During the meeting, Chairman Gensler amended the position limit rules to include a provision that allows the agency to provide an exemption on a case-by-case basis for firms to engage in hedging transactions that are not otherwise permitted by the rule, in response to concerns raised by Commissioners Dunn and Sommers.

Commissioners Sommers and Chilton each engaged the CFTC’s Chief Economist, Andrei Kirilenko, in a colloquy on the effect index funds may have on commodity prices, which included a question by Commissioner Sommers as to what additional analysis would be needed before exempting commodity index funds as a “person or class of persons” or establishing separate limits for them as a “group or class of traders,” citing former Chairman of the Senate Agriculture Committee Blanche Lincoln, who urged the CFTC to “implement position limits in a manner that protects ordinary investors and ensures that the commodity markets continue to benefit from the liquidity and price stability provided by unleveraged broad-based index investments.” In those colloquies, Mr. Kirilenko acknowledged that external literature had not reached a consensus and that internally, CFTC economists were “not yet at the point where I would feel comfortable saying that we have reached a firm quantitative conclusion” as to the effect index funds have on commodity prices.

COMMISSIONER O’MALIA’S DISSENT

Commissioner O’Malia heavily criticizes the Final Rules in a dissent included with the release accompanying the Final Rules (the “Dissent”), which also lays out legal arguments as to why the Final Rules are flawed. The Dissent argues that, although Dodd-Frank Act directs the CFTC to set limits “as appropriate”, this directive should be read in the context of the broader requirements that position limits be set “as appropriate . . . [and] to the maximum extent practicable in [the CFTC’s] discretion’ (1) to diminish, eliminate, or prevent excessive speculation as described under this section (section 4a of the Act), (2) to deter and prevent market manipulation, squeezes and corners, (3) to ensure sufficient market liquidity for bona fide hedgers, and (4) to ensure that the price discovery function of the underlying markets is not disrupted.” The Dissent emphasizes the discretion to set limits “as appropriate” that
Congress delegated to the CFTC statutorily, and reasons that the CFTC failed to properly exercise that discretion by imposing position limits under the Final Rules in the absence of “empirical evidence demonstrating that those [limits] would diminish, eliminate, or prevent excessive speculation.” The Dissent also repeatedly notes the failure to provide adequate cost-benefit analysis to support the Final Rules and observes that in promulgating them, the CFTC has “failed under the Administrative Procedure Act to provide a meaningful and informed opportunity for public comment.”

FRAMEWORK OF THE FINAL RULES

POSITION LIMITS

The Final Rules apply position limits on a spot month basis as well as on an all-month and any month basis to derivatives on the same 28 commodities contracts as specified under the Proposed Rules.

Referenced Contracts

The Final Rules adopted by the CFTC impose position limits on “Referenced Contracts.” The Referenced Contracts are defined by relation to 28 “Core Referenced Futures Contracts” in agricultural, metal and energy commodities. The 28 Core Referenced Futures Contracts are listed in Final Rule 151.2. A “Referenced Contract” is defined as (a) a Core Referenced Futures Contract; or (b) any futures contract, options contract, swap or swaption, other than a basis contract or contract on a commodity index, that is (1) directly or indirectly linked, including being partially or fully settled on, or priced at a fixed differential to, the price of such Core Referenced Futures Contract; or (2) directly or indirectly linked, including being partially or fully settled on, or priced at a fixed differential to, the price of the same commodity underlying such Core Referenced Futures Contract for delivery at the same location or locations as specified in such Core Referenced Futures Contract.

The Final Rules eliminate the category of Referenced Contracts based on “substantially the same supply and demand fundamentals,” which had been included in the Proposed Rules. In explaining the decision to exclude this category, the Adopting Release notes that implementing the “substantially the same supply and demand fundamentals” criterion may require access to “data concerning bids and offers and transaction information regarding the cash market, which are not readily available to the [CFTC] at this time.”

The Final Rules separate Referenced Contracts into two classes: physically settled contracts and cash-settled contracts.

Spot-Month and Non-Spot-Month Position Limits

Final position limits will become effective in two stages. In the first stage, spot-month limits will be imposed with respect to all Referenced Contracts based on existing Designated Contract Market (“DCM”) limits and currently available data at levels specified in Final Part 151 Appendix A; in this stage, non-spot-month limits will also be imposed on nine legacy Referenced Contracts (all agricultural contracts already
subject to non-spot-month limits) at levels prescribed by the Final Rules. The compliance date for spot-month limits and non-spot-month legacy limits will be 60 days after the term “swap” is further defined by the CFTC pursuant to the Dodd-Frank Act. After this compliance date, 17 C.F.R. Part 150 will be revoked and market participants will be obligated to comply with all relevant provisions of 17 C.F.R. Part 151 with the exception of the non-spot-month limits for non-legacy Referenced Contracts.

Beginning on January 1 of the second calendar year after the term “swap” is further defined, the CFTC will fix the spot-month limits at 25% of the estimated deliverable supply. Thereafter, spot-month limits for agricultural Referenced Contracts will be set annually, while spot-month limits for energy and metal commodities will be set biennially. The dates for determining the spot-month limits based on the deliverable supply will be staggered throughout the year (whereas the Proposed Rules would have set the date for the new limits on January 31 of every year and on an annual basis for metal and energy contracts). According to the Adopting Release, “deliverable supply” generally means the quantity of the commodity meeting a derivative contract’s delivery specifications that can reasonably be expected to be readily available to short traders and saleable by long traders at its market value in normal cash marketing channels at the derivative contract’s delivery points during the specified delivery period, barring abnormal movement in interstate commerce. The CFTC may use estimates submitted by the DCMs or may reject these estimates and rely on its own estimate of deliverable supply. The DCMs must submit this estimate along with the methodology for calculating the estimate on the staggered schedule described in Final Rule 151.4(d)(2). In response to comments from market participants that the use of “deliverable supply” to set spot-month position limits would result in artificially reduced spot-month position limits, the CFTC stated that the use of deliverable supply to set spot-month limits is “wholly consistent with its historical approach to setting spot-month limits.”

Under the Final Rules, spot-month limits generally will apply separately to physically settled and cash-settled contracts (i.e., a trader may hold positions during the spot-month in physically settled contracts in an amount up to the spot-month limit and may separately hold positions in cash-settled contracts up to that limit). A trader may not net positions across physically settled and cash-settled contracts for purposes of applying spot-month limits.

Unique spot-month limits apply to New York Mercantile Exchange Henry Hub Natural Gas Referenced Contracts (“Natural Gas Contracts”). As with other Referenced Contracts, the physically settled spot-month limit for Natural Gas Contracts is set at 25% of the deliverable supply. However, Natural Gas Contracts are subject to a more permissive interim conditional limit for cash-settled contracts, which is equal to five times the physically settled limit. As an independent cap, Natural Gas Contracts are subject to an aggregate spot-month limit for cash-settled and physically settled contracts of five times the physically settled limit. As with other Referenced Contracts, a trader may not net physically settled Natural Gas Contracts with cash-settled Natural Gas Contracts when determining its spot-month positions, including its aggregate position. These interim conditional limits only apply to Natural Gas Contracts.
Contracts and allows a trader to hold both physically settled and cash-settled contracts, and still qualify for the conditional limit. This is a significant departure from the Proposed Rules, which had provided for conditional limits set at five times the limit of the relevant physically settled limit for all 28 Referenced Contracts.

In the second stage, all-months limits and any-month limits will be imposed with respect to non-legacy Referenced Contracts. Prior to the second stage, the CFTC will obtain or estimate 12 months of data on the open interest levels. To determine initial non-spot-month position limits for non-legacy Referenced Contracts, Final Rule 151.4(b)(2)(ii) permits the CFTC to use uncleared open swaps positions reported under 17 C.F.R. § 20.4 by clearing organizations or clearing members that are swap dealers.

As in the Proposed Rules, the Final Rules will impose the same limit on any-month positions and all-months-combined positions for non-legacy Referenced Contracts. These limits will be determined as a function of the open interest in the Referenced Contract, determined as ten percent of the open interest up to the first 25,000 contracts plus two and a half percent of open interest thereafter (the “10-2.5 percent formula”). The Adopting Release describes this as “the same formula that has been historically used to set position limits on futures exchanges.”

Initial non-spot-month position limits for non-legacy agricultural, energy and metal Referenced Contracts will be fixed and published within one month after the CFTC has obtained or estimated 12 months of data with respect to open interest in Referenced Contracts under Final Rule 151.4(d)(3)(i). Subsequent non-spot-month limits for non-legacy Referenced Contracts will be calculated as the higher of the 12 month average of all-month-combined aggregate open interest, or the 24 month average of all-months-combined aggregate open interest and revised in accordance with the staggered schedule provided in Final Rule 151.4(e). The public would have two months advance notice of the position limit levels.

The release accompanying the Proposed Rules sought comment as to whether the CFTC should impose current limits in connection with legacy Core Referenced Futures Contracts, limits proposed by the CME, or the 10-2.5 percent formula. In the Final Rules, the CFTC decided to use the all-months-combined position limit levels proposed by the CME as the basis for setting limits for the nine legacy agricultural Core Referenced Futures Contracts. These new limits are based on 2009 average month-end open interest. For two legacy agricultural Core Referenced Futures Contracts, KCBT wheat and MGEX wheat, levels were set based on CBOT wheat.

Notably, the Final Rules will permit market participants to net futures positions with economically equivalent swaps to calculate both spot-month positions and non-spot-month positions, which would not have been permitted under the Proposed Rules. The Adopting Release expressed the view that inter-class netting would not result in increased potential market abuse, and the CFTC stated that it could address any potential market abuse arising from inter-class netting with its large trader surveillance.
The Final Rules also allow traders to net cash-settled contracts with physically settled contracts when determining non-spot-month position levels.

The Final Rules, as contemplated in the Proposed Rules, apply the position limits on an intra-day basis, which the Adopting Release notes is consistent with existing CFTC and DCM policy.

**BONA FIDE HEDGING AND OTHER EXEMPTIONS**

As discussed in the Proposed Rules, the new statutory definition of bona fide hedging under the Dodd-Frank Act altered the preexisting definition in significant ways. In response to a substantial number of comments to the Proposed Rules, many from commercial market participants, the CFTC made several changes to the bona fide hedging provisions described in the Proposed Rules, notably:

- The Final Rules include anticipatory merchandising activity, anticipated royalty payments, and service contracts as enumerated bona fide hedging transactions, which as discussed below are very narrowly defined;
- The Final Rules will allow market participants to use notice filings with respect to claims for hedge exemptions, as opposed to requiring approval from the CFTC as set out in the Proposed Rules;
- The Final Rules will allow traders to hold cash-settled contracts up to the last day of trading as bona fide hedging transactions;
- The Adopting Release clarifies that portfolio hedging is permitted and clarifies the conditions under which swaps executed opposite a commercial counterparty would be recognized as the basis for bona fide hedging; and
- The Final Rules also provide an exemption for situations involving “financial distress.”

**Bona Fide Hedging Transactions**

To qualify as a bona fide hedging transaction under the Final Rules, a transaction or position must (1) represent 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) be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, and (3) either (a) both qualify as one of the eight enumerated bona fide hedging transactions under Final Rule 151.5(a)(2) and arise from the potential change in the value of certain assets, liabilities or services, or (b) qualify as a “pass-through swap”, as elaborated further below. Furthermore, the transaction or position hedged must be established and liquidated in an orderly manner in accordance with sound commercial practices. To aid hedgers seeking an exemption, the Final Rules include an appendix that lists some transactions that the CFTC deems to qualify for the bona fide hedge exemption. Each of the enumerated exemptions applicable to physical-delivery positions does not apply to a position maintained in any physical-delivery Referenced Contract during the last five days of trading of the Core Referenced Contract in an agricultural or metal commodity or during the spot month for other physical-delivery commodities.
The Final Rules provide a considerably narrower anticipatory hedging definition than the industry has long relied upon. In response to comments, the Final Rules provide hedging exemptions for anticipated merchandising activity, royalty payments, and service contracts under certain circumstances.

To qualify for the anticipatory merchandising exemption, the offsetting sales and purchases in Referenced Contracts (1) in quantity, may not exceed the amount of the same cash commodity that is anticipated to be merchandised, (2) in quantity, may not be larger than the current or anticipated unfilled storage capacity owned or leased by the same person during the period of anticipated merchandising activity, which may not exceed one year, and (3) must be in the form of a calendar spread, which settles in not more than one year.

Anticipatory royalty hedging is permitted against the value of royalty rights owned by the hedging person, provided that the royalty rights arise out of the production, manufacturing, processing, use or transportation of the commodity underlying the Referenced Contract, which may not exceed one year for agricultural Referenced Contracts. Similarly, service hedging is permitted against the value of receipts or payments due or expected to be due under an executed contract for services held by the hedging counterparty, provided that the contract for services arises out of the production, manufacturing, processing, use or transportation of the commodity underlying the Referenced Contract, which may not exceed one year for agricultural Referenced Contracts; furthermore, the fluctuations in value of the position in Referenced Contracts must be substantially related to the fluctuations in value of receipts or payments due or expected to be due under a contract for services.

As noted above, the CFTC received numerous comments regarding the limitations of the new hedging regime under the Proposed Rules. During the Open Meeting, in response to those comments, an amendment was adopted that permits a market participant who is engaging in risk-reducing practices commonly used in the market that the market participant believes may not be specifically enumerated as one of the eight enumerated bona fide hedging transactions to apply to the CFTC staff for relief under 17 C.F.R. § 140.99 or the CFTC under § 4a(a)(7) of the Commodity Exchange Act ("CEA") concerning the applicability of a bona fide hedging transaction exemption.

The Final Rules do not permit spread exemptions, because the any-month limit and the all-months-combined limit are set at the same level. In addition, the Final Rules do not permit netting of inter-commodity spreads unless the positions fall within the same category of Referenced Contracts. However, a trader offsetting multiple risks in the physical market might still qualify for a bona fide hedging exemption.

**PASS THROUGH SWAPS**

Final Rule 151.5(a) permits a person to qualify for a bona fide hedging exemption if entering into a “pass-through swap.” Specifically, the Final Rules provide that such person, a “non-bona fide counterparty” (i.e., the party that is not the bona fide hedger), who will usually be the dealer, may classify a position as
a bona fide hedging position if such person purchases or sells Referenced Contracts that reduce the risks attendant to the pass-through swap. A pass-through swap will qualify as a bona fide hedging transaction only if it is executed with a counterparty eligible to claim one of the eight enumerated hedge exemptions (a "bona fide counterparty"). Furthermore, the Adopting Release clarifies that the non-bona fide counterparty may classify a pass-through "swap as a bona fide hedging transaction only if [the non-bona fide counterparty] enters risk reducing positions . . . which offset the risk of the pass-through swap." The Final Rules generally do not allow the pass-through exemption to extend through a series of swap transactions.

Under the Proposed Rules, the non-bona fide counterparty was required to ask for a written representation from the bona fide counterparty that the transaction qualified as a bona fide hedging transaction. Upon receipt of the written representation, the non-hedging party would have to give written confirmation of receipt. In the Final Rules, the CFTC removed the requirement of obtaining written confirmation of receipt. Instead, a good-faith representation at inception that the transaction qualifies as an enumerated hedge is sufficient.

In response to comments, the Final Rules clarify that market participants qualify for the bona fide hedging exemption regardless of whether they hedge their market risk on a one-to-one transactional basis or combine the risk associated with a number of transactions and hedge the risk on a portfolio basis. The Final Rules also clarify that a transaction may qualify as a bona fide hedging transaction regardless of whether the hedger's position exceeds the position limit, and the bona fide hedging exemption will pass through to the counterparty regardless of whether the bona fide hedger exceeds the position limits.

**Filing Requirements for the Bona Fide Hedging Exemption**

The Final Rules significantly change the filing requirements to obtain a hedge exemption from the provisions in the Proposed Rules. Under the Proposed Rules, bona fide hedgers would have been required to file daily Form 404 or Form 404S reports once they exceeded the position limits. Under the Final Rules, a trader must notice file a Form 404 or a Form 404A, depending on the specific hedging exemption sought. A Form 404 must be submitted no later than on the third business day after the relevant position limit has been exceeded; the notice filing of a Form 404 becomes effective upon the date of its submission and without affirmative action by the CFTC. A pass-through swap counterparty must file a Form 404S in the same manner. A Form 404 must be submitted at least ten business days in advance of the relevant position limit being exceeded; the notice filing of a Form 404A becomes effective ten days after filing and without affirmative action by the CFTC. Anticipated merchandising hedges, anticipated royalty hedges, and service hedges (among others) must be filed on Form 404A. The CFTC may require a person submitting these notice filings to submit such other information, before or after the effective date of the notice, which is necessary to enable the CFTC to make a determination whether the transactions or positions under the notice fall within the scope of bona fide hedging transactions or
positions. The trader is required to file these reports monthly for as long as he or she exceeds the relevant position limit, in contrast to the Proposed Rules, which required daily filings.

**Transfer of Positions in Financial Distress**

The Final Rules also include a non-hedging exemption from position limits for circumstances of financial distress. The Adopting Release notes that several market participants observed that, during periods of financial stress, it may be beneficial for a financially sound entity to assume the positions and corresponding market exposure of a less stable market participant. In response, the Final Rules added an additional exemption for market participants, under which a financially sound entity could assume the positions of a less stable market participant for a time certain, upon specific request to the CFTC. The exemption for financial distress does not establish or otherwise represent a form of hedging exemption as this exemption is derived from the CFTC’s authority to grant “special exemptions” under section 4a(a)(7) of the CEA.

**AGGREGATION OF ACCOUNTS AND POSITIONS**

The Final Rules apply position limits to all positions in accounts for which any person by power of attorney or otherwise directly or indirectly holds positions or controls trading and to positions held by two or more persons acting pursuant to an expressed or implied agreement or understanding the same as if the positions were held by, or the trading of the position were done by, a single individual.31

**Ownership and Control Criteria**

The Final Rules generally require a person to aggregate all positions in accounts where it by power of attorney or otherwise directly or indirectly holds an ownership or equity interest of ten percent or more. The Final Rules require aggregation with respect to a person that is a limited partner, shareholder or other similar type of pool participant with an ownership or equity interest of ten percent or more (i) in a pooled account or positions, if such person is also a principal or affiliate of the operator of the pooled account, unless the person abides by certain control and information barriers and makes a filing pursuant to Final Rule 151.7(h), and (ii) in an account or position, if such person is a commodity pool operator; in addition, each limited partner, shareholder, or other similar type of pool participant having an ownership or equity interest of 25% or greater in a commodity pool the operator of which is exempt from registration under 17 C.F.R. § 4.13 must aggregate the pooled account or positions with all other accounts or positions owned or controlled by that person. The Final Rules also require aggregation of positions held by a futures commission merchant and its separately organized affiliates (collectively, an “FCM”) in discretionary accounts and accounts that are part of, participate in, or receive trading advice from a customer trading program of such FCM or any of its officers, partners, or employees unless (1) a trader other than the FCM directs trading in such an account, (2) the FCM 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, and (3) each trading decision on behalf of the discretionary account or the customer trading
CFTC to Impose Position Limits on Derivatives on 28 Physical Commodities

November 7, 2011

program is determined independently of all trading decisions in other accounts that the FCM holds or controls, or in which it has a financial interest of ten percent or more.

Under Final Rule 151.7(d), any person that holds or controls the trading of positions, by power of attorney or otherwise, in more than one account, or that holds or controls trading of accounts or positions in multiple pools with identical trading strategies must aggregate all such accounts or positions that such person holds or controls. The Adopting Release clarifies that the “general ownership threshold of 10 percent” is inapplicable to this provision. The Adopting Release also notes that the intent of this provision is “to prevent circumvention of the aggregation requirements.”

Independent Account Controller Exemption

The Proposed Rules would have eliminated the longstanding Independent Account Controller (“IAC”) exemption and restricted the existing disaggregation provisions, while creating a limited exemption for non-financial owned entities. In response to extensive comments from market participants, the CFTC decided to retain the IAC exemption based on the currently effective IAC exemption under 17 C.F.R. Part 150. The Adopting Release notes that:

“[The Final Rules] reaffirm the Commission’s current requirements [under Part 150] to aggregate positions that a trader owns in more than one account, including accounts held by entities in which that trader owns a 10 percent or greater equity interest. Thus, for example, a financial holding company is required to aggregate house accounts (that is, proprietary trading positions of the company) across all wholly-owned subsidiaries.”

The IAC exemption preserved by the Final Rules, therefore, permits disaggregation between proprietary positions and those managed on behalf of clients, subject to compliance with the requirements for adequate separation; the IAC exemption, however, does not permit proprietary positions to be disaggregated from other proprietary positions. The IAC exemption is no longer self-executing, as it has been under CFTC Part 150, and will require notice to the CFTC for relief, as discussed below. Under the Final Rules, the IAC exemption must be obtained through notice filing to the CFTC that is effective upon submission.

Other Exemptions from Aggregation Under the Final Rules

The Final Rules provide several additional exemptions from the aggregation requirements. Under Final Rule 151.7(g), a person need not aggregate the positions or accounts of an owned entity if the ownership interest is based on the ownership of securities constituting the whole or part of an unsold allotment to or subscription by such person as a participant in the distribution of such securities by the issuer or by or through an underwriter; this exemption from aggregation does not require notice to the CFTC. In response to extensive comments from market participants, the Final Rules also exempt a person from aggregation requirements if the sharing of information associated with such aggregation would violate federal law or regulations adopted thereunder and provided that the other person does not have actual
knowledge of such information; notice filed to obtain this exemption must include an opinion of counsel stating that the sharing of information would cause a violation of federal law or regulations adopted thereunder.

The Final Rules do not adopt the non-financial entity exemption discussed in the Proposed Rules. The non-financial entity exemption would have allowed a limited disaggregation exemption in situations where an entity owns ten percent or more or a non-financial entity such as an operating company. As noted in the Adopting Release, the CFTC believes that in light of the retention of the IAC exemption, the exemption for information sharing in violation of the law, and the underwriter’s exemption, "it would not be appropriate, at this time, to expand further the scope of disaggregation exemptions to owned–non financial or financial entities." This explanation is troubling since it does not address many of the situations where there is clear separation and the absence of control that had historically justified disaggregation.

**Obtaining Disaggregation Exemption Under the Final Rule**

Under the Proposed Rules, a market participant would have been required to receive approval from the CFTC before relying on an exemption from the aggregation rules. Under the Final Rules, to obtain an exemption from aggregation, a trader must make a notice filing. The notice filing is effective upon submission. This filing should discuss the circumstances that warrant disaggregation and certify that they meet the relevant conditions for the exemption. In the event of a material change to the information provided in the notice, an updated or amended notice must promptly be filed detailing the material change. Upon call by the CFTC, any person claiming a disaggregation exemption must provide relevant information concerning the claim for exemption. To the extent that the CFTC finds that a trader is not appropriately following the conditions of the exemption, upon notice and opportunity to respond, the CFTC may amend, suspend, terminate, or otherwise modify the aggregation exemption.

**PREEXISTING POSITIONS**

The Final Rules provide two exemptions for preexisting positions. First, market participants are exempted from initial position limits established under Final Rule 151.4 for swap positions entered into in good faith before the effective date of such limits. Such swap positions may be netted with post-effective date swaps and swaptions for the purpose of applying any position limits. Second, market participants are exempted from the non-spot-month position limits of Final Rule 151.4(b) with respect to positions in Referenced Contracts that remain open and were entered into in good faith prior to the effective date of any rule, regulation, or order specifying a position limit under the new Part 151. Although these positions will not be subject to the position limit rules, they are still subject to reporting under 17 C.F.R. § 20.4.

The Final Rules limit swap risk management exemptions granted under current 17 C.F.R. § 1.47 to swap positions that were entered into on or prior to the effective date of the initial position limits established under Final Rule 151.4.
When addressing the preexisting positions exemption in the context of index funds, the CFTC clarified that “index funds that ‘roll’ their preexisting positions after the effective date of a position limit rule do not fall within the scope of the preexisting position exemption.” Therefore, to the extent that an entity rolls its preexisting positions after the relevant effective date, such “new” positions will be subject to position limits.

**POSITION VISIBILITY**

The Final Rules require market participants to report when their positions in energy and metal Referenced Contracts in all-months or in any single month exceed certain thresholds, which are lower than the non-spot-month position limits. These thresholds are set forth in Final Rule 151.6. These position visibility reports will be required quarterly, but only during quarters in which the market participant exceeded the relevant level. The position visibility rule will become effective on the date that the new spot-month limits become effective.

**COMMODITY INDEX FUNDS**

As noted above, the definition of “Referenced Contract” does not include a “contract on a commodity index.” Thus, positions in such contracts themselves are not subject to the position limits of Final Rule 151.4. Nevertheless, commodity index swap users, including commodity index funds that rely on swaps (and indirectly, such funds’ investors), will be affected directly if they seek to offset the commodity index risks with individual commodity swaps or futures and indirectly if they elect to offset their risk using commodity index swaps. Commodity index swaps are normally entered into with dealers who hedge through positions in futures or swaps on single commodities. Many such single commodity contracts will become Referenced Contracts subject to Final Rule 151.4 position limits. However, dealers will not be able to net these futures or swaps with commodity index swaps sold to them by the funds because netting is only allowed between Referenced Contracts. In the absence of such netting, some dealers may be restricted in the volume of commodity index swaps they can carry and effectively offset without exceeding position limits.
The CFTC recognizes that, under amended section 4a(a)(1) of the CEA, the CFTC is empowered to establish position limits by “group or class of traders,” and under new section 4a(a)(7), the CFTC has authority to provide exemptions from position limits to any “person or class of persons.” However, the CFTC has explained that it “believes more analysis is required before [it] would impose a separate position limit regime, or establish an exemption, for a group or class of traders, including CIFs.” The CFTC has indicated that it welcomes “submissions of studies to assist in subsequent rulemakings on the treatment of various groups or classes of speculative traders.”

* * *
For additional information on the Proposed Rules, see our Memorandum to Clients, dated January 19, 2011, “CFTC Proposed Rules on Position Limits on Physical Commodity Derivatives.”

Adopting Release at 4. Commissioner O’Malia, in his dissent to the Adopting Release, observed that only approximately 100 of these letters were “substantive.” Adopting Release at 284.

Commissioner Dunn’s term expired on October 31, 2011 and he was replaced by Commissioner Wetjen.

Transcript at 6; see also Adopting Release at 272.


Adopting Release at 282.

Adopting Release 283-82.

The Final Rules require designated contract markets and swap execution facilities to impose position limits for Referenced Contracts at levels no greater than similar limits imposed by the CFTC on Referenced Contracts.

A “basis contract” is defined as a contract that is cash-settled and “based on the difference in price of the same commodity (or substantially the same commodity) at different delivery locations.” Final Rule 151.1.

Final Rule 151.1 defines “commodity index contract” as “an agreement, contract, or transaction that is not a basis or any type of spread contract, based on an index comprised of prices of commodities that are not the same or substantially the same; provided that, a commodity index contract used to circumvent speculative position limits shall be considered to be a Referenced Contract for the purpose of applying the position limits of § 151.4.”

Adopting Release at 17.

There is no definite timetable for adopting a definition for the term “swap” pursuant to section 721 of the Dodd-Frank Act. As of the date of this memorandum, no definition has yet been proposed.

Spot-month position limits for cash-settled contracts (other than natural gas) are set at 25 percent of estimated deliverable supply on an interim final rule basis. Adopting Release at 34. The CFTC states, in the Adopting Release, that these will be revisited “after [the CFTC] evaluates the effects of the interim final rule.” Adopting Release at 38.

Adopting Release at 28.

Final Rule 151.4(d)(2)(iv) permits designated contract markets to use any guidance adopted in the Acceptable Practices for Compliance with Core Principle 3 found in part 38 of the Commission’s regulations for purposes of estimating deliverable supply.

Adopting Release at 27.

But see discussion of Natural Gas Contracts, infra.

For purposes of applying aggregate spot-month position limit in Natural Gas Contracts, netting of physical-delivery and cash-settled Reference Contracts is required. Final Rule 151.4(c)(ii).

The Adopting Release explained the separate treatment on the basis of there being “very active” cash-settled markets, referencing NYMEX and ICE, for cash-settled natural gas futures contracts linked to the physical-delivery contracts. Adopting Release at 37. The Adopting Release further stated that the CFTC does not believe that conditional limits on these cash-settled contracts have materially diminished the price discovery function of the physical-delivery contracts. For a detailed discussion of the CFTC’s reasoning for not providing conditional limits on other commodities, see the Adopting Release at 35-37.
The CFTC adopted regulations for Large Trading Reporting for Physical Commodity Swaps in July of 2011. Large Trading Reporting for Physical Commodity Swaps, 76 F.R. 43851 (Jul. 22, 2011) (“Final Large Trader Rules”). The Adopting Release explains that the CFTC plans to use positional data obtained through reports provided under the Final Large Trader Rules as “a primary source for determining open interest.” See Adopting Release at 23, n. 60. Reporting obligations for clearing organizations and clearing members under the Final Large Trader Rules were to go into effect 60 days after the publication of the rules in the Federal Register, but that effective date has been subsequently delayed. After gathering 12 months of data on open interest, the CFTC will then review the data and issue an order setting the position limits, giving market participants two months to comply with the new limits. Therefore, it appears that the second phase limits (i.e., any-month and all-months-combined limits) will take effect no earlier than late 2012 or early 2013.

Adopting Release at 166.

Adopting Release at 62.

Adopting Release at 63.

The Adopting Release notes that a hedge can only be maintained so long as the trader is reasonably certain that he or she will engage in the anticipated merchandising activity. Adopting Release at 76.

See Adopting Release at 70.

Adopting Release at 78.

Final Rule 151.5(b) provides that entities required to aggregate accounts or positions under Final Rule 151.7 shall be considered the same person for the purposes of determining whether a person or persons are eligible for a bona fide hedge exemption under Final Rule 151.5(a).

Under Final Rule 151.5(i), the written representation must be retained by both parties for a period of at least two years following the expiration of the swap and furnished to the Commission upon request. The person making the representation must keep and make available to the Commission upon request all relevant books and records supporting such representation for a period of at least two years following the expiration of the swap.

The proposed text of Final Rule 151.5(a) was modified in a technical manner to clarify this point.

The Adopting Release clarifies that “the Commission interprets the ‘hold’ or ‘control’ criterion as applying separately to ownership of positions and to control of trading decisions.” Adopting Release at 94, n. 244.

Adopting Release 104.

Adopting Release at 93.

Final Rule 151.7(h); Adopting Release at 92, n. 241.

Adopting Release at 103.

Adopting Release at 106-07.

Part 20 of the CFTC regulations provides for data collection from reporting entities on a significant number of transactions, now including swaps entered into before the effective date of the Final Rules. See 17 C.F.R. § 20.4.

Adopting Release at 110.

Adopting Release at 111.

Adopting Release at 115.
CFTC to Impose Position Limits on Derivatives on 28 Physical Commodities
November 7, 2011
SC1:3130180.9