

# CFTC Re-Proposes Position Limits for 28 Physical Commodity Futures, Options and Swaps and Revised Aggregation Standards

November 18, 2013

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On November 5, 2013, the Commodity Futures Trading Commission proposed rules to establish new position limits that would apply to 28 agricultural, energy and metals futures contracts, and swaps, futures and options that are economically equivalent to those contracts.<sup>1</sup> Once adopted, the proposal would reinstate, with certain changes, the position limit rules that were vacated by a U.S. federal court in 2012 (the “**Vacated Rules**”).<sup>2</sup> The CFTC also re-proposed aggregation standards that are similar to those initially proposed as amendments to the Vacated Rules, but with a few notable differences, to be used in applying position limits (the “**Aggregation Proposal**”).<sup>3</sup>

The proposals would:

- specify initial spot-month and non-spot-month limits for covered futures, options and swap positions;
- revise the definition of bona fide hedging for purposes of the hedge exemption;
- create several new exemptions from the limits;
- define responsibilities of designated contract markets (“**DCMs**”) and swap execution facilities (“**SEFs**”) for establishing and enforcing position limits and position accountability rules; and
- establish revised aggregation standards.

Comments on both proposals are due 60 days after publication of the rules in the *Federal Register* (by January 14, 2014 for the Aggregation Proposal, which was published on November 15, 2013).

<sup>1</sup> CFTC Proposed Rule on Position Limits for Derivatives, available [here](#).

<sup>2</sup> Final Position Limits for Futures and Swaps, 76 Fed. Reg. 71,626 (Nov. 18, 2011), available [here](#). These rules established a new Part 151 of the CFTC’s regulations and were in large part vacated by a court decision in September 2012. See *Int’l Swaps and Derivatives Ass’n v. Commodity Futures Trading Comm’n*, Civil Action No. 11-cv-2146 (RLW), 2012 Dist. LEXIS 139788 (D.D.C. Sept 28, 2012).

<sup>3</sup> CFTC Proposed Rule on Aggregation of Positions, 78 Fed. Reg. 68,946 (Nov. 15, 2013), available [here](#); CFTC Proposed Rule on Aggregation, Position Limits for Futures and Swaps, 77 Fed. Reg. 31,767 (May 30, 2012), available [here](#).

**Core Referenced Futures Contracts**

- **Legacy Agricultural:**
  - CBOT Corn (C)
  - CBOT Oats (O)
  - CBOT Soybeans (S)
  - CBOT Soybean Meal (SM)
  - CBOT Soybean Oil (SO)
  - CBOT Wheat (W)
  - KCBT Hard Winter Wheat (KW)
  - ICE Futures U.S. Cotton No. 2 (CT)
  - MGE Hard Red Spring Wheat (MWE)
- **Other Agricultural:**
  - CBOT Rough Rice (RR)
  - CME Class III Milk (DA)
  - CME Feeder Cattle (FC)
  - CME Lean Hog (LH)
  - CME Live Cattle (LC)
  - ICE Futures U.S. Cocoa (CC)
  - ICE Futures U.S. Coffee C (KC)
  - ICE Futures U.S. FCOJ-A (OJ)
  - ICE Futures U.S. U.S. Sugar No. 11 (SB)
  - ICE Futures U.S. U.S. Sugar No. 16 (SF)
- **Energy:**
  - NYMEX Light Sweet Crude Oil (CL)
  - NYMEX NY Harbor ULSD (HO)
  - NYMEX RBOB Gasoline (RB)
  - NYMEX Henry Hub Natural Gas (NG)
- **Metals:**
  - CEI Gold (GC)
  - CEI Silver (SI)
  - CEI Copper (HG)
  - NYMEX Palladium (PA)
  - NYMEX Platinum (PL)

**Contracts Subject to the Position Limits**

The position limit proposal would amend the existing position limit rules in Part 150 of the CFTC’s regulations to create a new position limit regime for 28 physical commodity futures and economically equivalent futures, options and swaps. The 28 physical commodity futures contracts are the same contracts as were covered by the Vacated Rules. The proposed rules would designate the 28 futures contracts listed in the sidebar as “**Core Referenced Futures Contracts.**” These include the nine agricultural futures contracts that are currently subject to CFTC position limits under Part 150 (“Legacy Agricultural” contracts), and ten additional agricultural contracts, four energy contracts and five metals contracts that are not currently subject to CFTC-set position limits.

The position limits would apply to a person’s positions in a Core Referenced Futures Contract combined with all futures, options and swap positions that are economically equivalent to that Core Referenced Futures Contract (together, “**Referenced Contracts**”). Economically equivalent contracts would include contracts directly or indirectly linked, including being partially or fully settled on, or priced at a fixed differential to:

- the price of a Core Referenced Futures Contract; or
- the price of the same commodity with the same delivery location or locations as a Core Referenced Futures Contract.

As under the Vacated Rules, Referenced Contracts include calendar spread contracts and intercommodity spread contracts, each as defined in the sidebar on page 3. They also include Referenced Contracts traded on a foreign board of trade (“**FBOT**”) that settle against the price (including the daily or final settlement price) of one or more contracts listed for trading on a DCM or SEF and that the FBOT makes available for trading in the United States.

Like the Vacated Rules, the proposal excludes basis contracts and commodity index contracts, each as defined in the sidebars on pages 3 and 4, from the definition of Referenced Contracts. The proposal also expands the definition of basis contract from that in the Vacated Rules to include, in addition to location basis contracts, commodity quality basis contracts, which are contracts based on the price difference between a commodity underlying a Referenced Contract and an economically closely related commodity. Appendix B to the proposal contains a list of commodities that are economically closely related for purposes of the basis contract definition.

**Position Limit Levels**

The position limits set the maximum amount of a Referenced Contract, on a futures-equivalent basis, that a person may own or control absent an exemption. Like the existing Part 150 limits and the Vacated Rules, the proposed rules would establish both spot-month and non-spot-month limits.

**Spot-Month Limits**

The CFTC proposes to establish initial spot-month limits at existing exchange-set levels, but requests comment on whether it should set initial

**Contracts Included as “Referenced Contracts”**

**Calendar spread contract:** a cash-settled agreement, contract or transaction that represents the difference between the settlement price in one or a series of contract months of an agreement, contract or transaction and the settlement price of another contract month or another series of contract months’ settlement prices for the same agreement, contract or transaction.

**Intercommodity spread contract:** a cash-settled agreement, contract or transaction that represents the difference between the settlement price of a Referenced Contract and the settlement price of another contract, agreement or transaction that is based on a different commodity.

**Contracts Excluded from “Referenced Contracts”**

**Basis contract:** a commodity derivative contract that is cash-settled based on the difference in:

1. the price, directly or indirectly, of:
  - (a) a particular Core Referenced Futures Contract; or
  - (b) a commodity deliverable on a particular Core Referenced Futures Contract; and
  
2. the price, at a different delivery location or pricing point than that of the same particular Core Referenced Futures Contract, directly or indirectly, of:
  - (a) a commodity deliverable on the same particular Core Referenced Futures Contract; or
  - (b) a commodity that is listed in Appendix B of Part 150 as substantially the same as a commodity underlying the same Core Referenced Futures Contract.

spot-month limits at 25% of the estimated deliverable supply of the commodity underlying a Core Futures Referenced Contract, based on data provided by DCMs and SEFs. The CFTC proposes to reset the spot-month limits at least every two years to a level no greater than 25% of the estimated deliverable supply of a commodity underlying a Referenced Contract, based on data provided by DCMs and SEFs that list the relevant contracts. As under the Vacated Rules, the proposed spot-month limits would apply separately to a person’s spot-month positions in a physical-delivery Referenced Contract and cash-settled positions in the same Referenced Contract, such that physical-delivery and cash-settled positions could not be netted in the spot month.

**Conditional Spot-Month Limits**

The proposal would permit a person to acquire positions of up to five times the spot-month limit for any Referenced Contract, if all of the person’s spot-month positions in that Referenced Contract are only in cash-settled contracts. This is an expansion of the conditional spot-month provision of the Vacated Rules, which applied only to positions in NYMEX Henry Hub Natural Gas. A person would need to file Form 504 to claim this exemption.

**Non-Spot-Month Limits**

As under the Vacated Rules, the proposed single-month and all-months-combined non-spot-month limits would be set at the same level. The initial level for non-spot-month limits for each Referenced Contract would be based on current estimates of open interest and each initial level is set forth in Appendix D to the proposal. The CFTC would reset these levels at least every two years at the sum of:

- 10% of the estimated average open interest of the first 25,000 contracts; and
- 2.5% of the open interest above the first 25,000 contracts.

The CFTC would estimate average open interest in Referenced Contracts using data reported to it under the futures and swaps large trader reporting regimes in Part 16 and Part 20 of the CFTC’s regulations and swap data reporting under Part 45 of the CFTC’s regulations.

**Netting of Positions Across Referenced Contracts**

Under the proposal, as under the Vacated Rules, position limits would apply to a person’s positions across all types of Referenced Contracts, whether futures, options or swaps, and whether transacted on a DCM or SEF or bilaterally. However, short and long positions in the same Referenced Contract are to be netted when measuring against the limit, except for cash-settled and physically-settled Referenced Contracts in the spot month, as mentioned above.

**Exemptions from Position Limits**

**Bona Fide Hedging**

Section 4a(a)(2) of the Commodity Exchange Act exempts positions that qualify as bona fide hedges from position limits. The proposal would

**Contracts Excluded from  
“Referenced Contracts” (cont.)**

**Commodity index contract:** 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.

**Enumerated Hedging Positions**

▪ **Anticipatory hedging positions include hedges of:**

- unfilled anticipated requirements;
- unsold anticipated production;
- anticipated royalties;
- anticipated changes in value of payments under service contracts; and
- anticipatory cross-commodity hedges.

▪ **Non-anticipatory hedging positions include hedges of:**

- inventory and cash commodity purchase contracts;
- cash commodity sales contracts;
- offsetting unfixed-price cash commodity sales and purchases;
- commodity derivative contracts by an agent; and
- non-anticipatory cross-commodity hedges.

amend the definition of bona fide hedging under current CFTC regulation 1.3(z) for purposes of CFTC and DCM and SEF position limits.

For a position in any commodity to qualify as a bona fide hedge, it must be (i) taken for the purpose of offsetting price risks incidental to commercial cash, spot or forward operations, (ii) established and liquidated in an orderly manner and (iii) economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise. In addition, the proposal would impose different factors for a position to qualify as a bona fide hedge, depending on whether the position is in an agricultural or exempt (metals and energy) commodity or in an excluded (generally financial) commodity.

*Excluded commodity bona fide hedges.* For a position in an excluded commodity to qualify as a bona fide hedge, the position would need to be an enumerated hedging position, as described below, or, if traded on a DCM or SEF, would need to qualify as a risk management position recognized as a bona fide hedge under the rules of the DCM or SEF. Appendix A to the proposed rules incorporates concepts from the CFTC’s 1987 interpretive statement on risk management exemptions as guidance for DCMs and SEFs in adopting risk management hedge requirements.

*Physical commodity bona fide hedges.* A bona fide hedge in an agricultural or exempt commodity must represent a substitute for a transaction made or to be made in a physical marketing channel and must arise from the change in value of specified assets, liabilities or services. The position must also be an enumerated hedging position.

*Enumerated hedging positions.* The proposed rule provides for eight types of enumerated hedging positions, plus cross-commodity hedges of those positions, as listed in the sidebar. These enumerated hedging positions are largely similar to the enumerated hedging positions in the Vacated Rules but reflect a significant deletion (unfilled storage capacity) and several additions.

To claim a bona fide hedge exemption, for non-anticipatory hedges, a person must file Form 204 with the CFTC; for anticipatory hedges, the person must file Form 704 at least ten days prior to exceeding the relevant position limit.

*Pass-through swaps.* A person that enters into a swap with a counterparty that claims the bona fide hedge exemption for the swap also may treat the swap as a bona fide hedge under the “pass-through swap” exemption, even though the person does not otherwise meet the requirements for the swap to be a bona fide hedge. A pass-through swap may be deemed to be a bona fide hedge only to the extent that the pass-through swap is itself hedged by positions in Referenced Contracts. Positions in Referenced Contracts to hedge a pass-through swap would also be deemed bona fide hedges. A person relying on the pass-through swap exemption to exceed a position limit must obtain a written representation from its counterparty that the swap qualifies as a bona fide hedge and must file Form 604 with the CFTC.

### ***Pre-Existing Positions***

Pre-existing positions in futures and options on futures entered into in good faith prior to the effective date of final position limit rules would be subject only to spot-month limits. This exemption would become unavailable if a person increases his positions in the relevant Referenced Contract after the effective date of final position limit rules.

The proposal also exempts swaps entered into prior to the effective date of the rules from both the spot-month and non-spot-month position limits. In addition, such swap positions acquired in good faith may be netted with post-effective date positions in Referenced Contracts for purposes of complying with the non-spot-month limits.

### ***Additional Exemptions***

The proposal, similar to the Vacated Rules, would provide exemptions upon request to the CFTC for cases of financial distress, such as situations involving the potential default or bankruptcy of a customer or a potential acquisition, and for other “commonly-used” risk-reducing practices that are not enumerated in the bona fide hedging definition. The proposal contemplates that exemptions previously granted for swap risk management purposes would not apply to swap positions entered into after the effective date of the final position limit rules.

### **Aggregation Standards**

Contemporaneously with proposing the position limit rules, the CFTC re-proposed aggregation standards for position limits purposes (the “**Aggregation Proposal**”).<sup>4</sup> While the Aggregation Proposal is similar in most respects to the prior aggregation proposal, it provides additional flexibility in some areas.

### ***Aggregation Requirement***

As under the current Part 150 position limits and the Vacated Rules, the Aggregation Proposal would require a person to aggregate:

- positions in accounts for which the person, by power of attorney or otherwise, directly or indirectly controls trading;
- positions in accounts for which the person, directly or indirectly, holds a 10% or greater ownership or equity interest; and
- positions in accounts or pools with substantially identical trading strategies, regardless of whether an exemption is available.

### ***Exemptions from Aggregation***

The Aggregation Proposal would provide several exemptions from the aggregation requirement.

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<sup>4</sup> See Footnote 3, above.

**Exemption for Holdings of a Commodity Pool**

A limited partner, limited member, shareholder or other similar participant in a commodity pool that holds a 10% or greater interest in the pool would not need to aggregate the positions of the pool with the person’s other positions, except that such person must aggregate the pool’s positions with all other accounts the person owns or controls if the person:

- is the pool’s commodity pool operator (“CPO”);
- has a 25% or greater ownership or equity interest in the pool and the CPO is exempt from registration under CFTC regulation 4.13; or
- is a principal or affiliate of the CPO, *unless* the person and the CPO meet requirements designed to ensure independence of trading of the commodity pool from that of the principal or affiliate.

**Eligible Entity Definition**

**Eligible entity includes:**

- a CPO (whether registered or exempt or excluded from registration); limited partner, limited member or shareholder in a commodity pool the operator of which is exempt from registration;
- a commodity trading advisor;
- a bank or trust company;
- a savings association;
- an insurance company; or
- the separately organized affiliates of any of the above entities:

which authorizes an IAC independently to control all trading decisions with respect to the eligible entity’s client positions and accounts that the IAC holds directly or indirectly, or on the eligible entity’s behalf, but without the eligible entity’s day-to-day direction; and

which maintains:

- only such minimum control over the IAC as is consistent with its fiduciary responsibilities to the managed positions and accounts, and necessary to fulfill its duty to supervise diligently the trading done on its behalf; or
- if a limited partner, limited member or shareholder of a commodity pool the operator of which is exempt from registration, only such limited control as is consistent with its status.

**Exemptions for Owned Entities**

*10% to 50% ownership.* Any person with an ownership or equity interest in an entity of 10% or greater, but not more than 50%, need not aggregate the positions of the owned entity, provided that the owner and owned entity:

- do not have knowledge of the trading decisions of each other;
- trade pursuant to separately developed and independent trading systems;
- have and enforce written procedures to preclude each from having knowledge of, gaining access to, or receiving data about trades of the other. These procedures must include document routing and other procedures or security arrangements, including separate physical locations, which would maintain the independence of their activities;
- do not share employees that control the trading decisions of either; and
- do not have risk management systems that permit the sharing of trades or trading strategy.

An owner seeking to disaggregate an owned entity’s positions under this exemption would need to submit a notice filing with the CFTC to claim the exemption.

*Greater than 50% ownership.* In a significant change from the prior proposal, the Aggregation Proposal would provide an exemption from aggregation for positions of an owned entity where the owner has a greater than 50% ownership or equity interest in the owned entity. To rely on this exemption, the owner and owned entity would need to meet the requirements listed above for 10-to-50% owned entities and several additional, significantly limiting conditions. These include that the entities are not required to, and do not, consolidate their financials under U.S. GAAP; the owned entity’s positions either all qualify as bona fide hedges or do not exceed 20% of any applicable position limit; and the entities have in place specified policies and meet detailed conditions designed to ensure

**IAC Proposed Amended Definition**

**Independent Account Controller means a person:**

- who specifically is authorized by an eligible entity, independently to control trading decisions on behalf of, but without the day-to-day direction of, the eligible entity;
- over whose trading the eligible entity maintains only such minimum control as is consistent with its fiduciary responsibilities to the managed positions and accounts to fulfill its duty to supervise diligently the trading done on its behalf or as consistent with such other legal rights or obligations which may be incumbent upon the eligible entity to fulfill;
- who trades independently of the eligible entity and of any other independent account controller trading for the eligible entity;
- who has no knowledge of trading decisions by any other independent account controller; and
- who is:
  - (i) registered as an FCM, an IB, a CTA, or an associated person of any such registrant; or
  - (ii) is a general partner, managing member or manager of a commodity pool the operator of which is exempt from registration under CFTC regulations 4.5(a)(4) or 4.13.

independence of trading. The owner must apply for, and receive approval from, the CFTC to rely on this exemption.

**Other Exemptions**

*Exemption for accounts carried by an independent account controller.* As under the current Part 150 position limit rules, the Aggregation Proposal provides that an “eligible entity,” as defined in the sidebar on page 6, that has authorized an independent account controller (an “IAC,” as summarized in the sidebar) to trade client positions on its behalf need not aggregate positions controlled by the IAC with its own, subject to conditions designed to ensure independence of trading between the eligible entity and the IAC. Additional conditions apply to an eligible entity and IAC that are affiliates. The IAC exemption is not available for spot-month positions in physical-delivery Referenced Contracts. The eligible entity must make a notice filing with the CFTC prior to relying on this exemption.

The Aggregation Proposal also includes several other exemptions, including:

- *Exemption for accounts held by FCMs.* An FCM need not aggregate the positions of a discretionary account directed by an unaffiliated third party, subject to conditions similar to those under the existing Part 150 position limit rules. The FCM must file a notice filing with the CFTC to rely on this exemption.
- *Exemption for underwriting.* A person need not aggregate the positions 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 such person as the participant in a securities distribution by the issuer or an underwriter. There is no notice filing requirement for this exemption.
- *Exemption for broker-dealer activity.* A registered broker-dealer need not aggregate the positions of an owned entity if it has an ownership interest of 50% or less that is acquired in the normal course of business as a dealer, provided that the broker-dealer does not have actual knowledge of the trading decisions of the owned entity. There is no notice filing requirement for this exemption.
- *Exemption for information sharing restriction.* A person need not aggregate the positions of an owned entity if the information sharing associated with such aggregation creates a reasonable risk that the person or owned entity could violate state, federal or foreign law. The person must make a notice filing with the CFTC, which must include a memorandum of law (which need not be prepared by outside counsel) explaining the basis for the exemption.
- *Exemption from notice filing for higher-tier entities.* A higher-tier entity, meaning a person with an ownership interest of 10% or more in another entity, would not separately have to make a notice filing with the CFTC to rely on an exemption if the owned entity has already submitted a required notice filing. The higher-tier entity must comply with the conditions applicable to

the exemption (other than the notice filing requirement) and cannot otherwise control the trading of the positions identified by the owned entity in the notice.

### Other Noteworthy Aspects of the Proposals

Several other aspects of the proposed rules may be of interest to market participants as they assess the potential implications of the proposed rules.

- The position limit proposal affirms that commodity trade options qualifying for the trade option exemption under CFTC regulation 32.3 are subject to position limits. The CFTC requests comment on whether it should exclude trade options from the position limits.
- The position limit proposal, similar to the Vacated Rules, requires DCMs and SEFs on which Referenced Contracts trade to adopt and enforce position limits in Referenced Contracts at levels no less strict than those established by the CFTC. The rules also propose standards for acceptable position limits and position accountability rules for contracts other than Referenced Contracts.
- The proposals could impose various additional compliance and reporting requirements on market participants that trade Referenced Contracts, including filing and reporting requirements in connection with claiming certain exemptions from the position limits and from aggregation standards, as discussed above.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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