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CFTC Adopts Final Position Limits for 28 Physical Commodity Futures, Options, and Swaps

On October 18, 2011, a divided CFTC approved final rules that establish position limits for 28 exempt (metals and energy) and agricultural commodities. The rules cover futures and options contracts on these commodities and swaps, futures, and options that are economically equivalent to those contracts. Dissenting CFTC Commissioners Sommers and O'Malia each voiced strong concerns about the economic basis for the rule, the effectiveness of the rule in addressing price volatility, and the impact of the new bona fide hedging definition upon legitimate risk-reducing strategies. Nonetheless, the rules were adopted and will become effective 60 days after their publication in the *Federal Register*.

The final rules establish a new Part 151 of the CFTC's regulations which, among other things:

- Defines new standards for calculating position limits in spot and non-spot months for the relevant physical commodity contracts;
- Defines contracts eligible to be netted, *e.g.*, swaps economically equivalent to futures contracts outside of the spot month, for purposes of determining a trader's position;
- Establishes revised aggregation standards;
- Implements a new statutory definition of bona fide hedging;
- Establishes effective dates for the final rules and exemptions for pre-existing positions;
- Establishes position visibility reporting requirements; and
- Defines responsibilities of DCMs and SEFs for establishing and enforcing position limits and position accountability rules.

The position limits will be phased in depending on the relevant contract, as described in more detail below.

Contracts Subject to the Position Limits

The CFTC chose 28 physical commodity contracts to be subject to position limits based on their high levels of open interest and significant notional value or because they serve as a reference price for a significant number of cash market transactions. The final rules expand the types of futures contracts subject to CFTC position limits and for the first time apply position limits to "economically equivalent" swaps.

The position limits apply to nine "legacy" agricultural contracts, which are currently subject to CFTC position limits, and to ten non-legacy agricultural contracts, four energy contracts, and five metal contracts that are not currently subject to CFTC position limits. These contracts are termed **Core Referenced Futures Contracts** by the rules.

An economically equivalent futures contract, option contract, or swap includes any contract that is linked or priced at a fixed differential to: (1) the price of a Core Referenced Futures Contract or (2) the price of the same commodity with the same delivery location as a Core Referenced Futures Contract. The Core Referenced Futures Contracts, together with their economically equivalent contracts, are termed **Referenced Contracts**, and the new position limits apply across all Referenced Contracts on the same commodity. In adopting the final rules, the CFTC clarified that Referenced Contracts include contracts priced at a differential, including spread contracts with both price components based on Referenced Contracts; intercommodity spread contracts with two reference price components, one or both of which are based on Referenced Contracts; and contracts that are priced at a fixed differential to a Core Referenced Futures Contract.

A contract on an index based on the price of a single commodity may be a Core Referenced Futures Contract, depending on the underlying commodity; however, contracts on diversified commodity indexes are not covered by the new position limits. Basis contracts, that is, cash-settled contracts based on the differences in the price of a commodity at different delivery locations, are not Referenced Contracts.

Position Limit Levels

The position limit levels set the maximum amount of a Referenced Contract a trader may own or control separately or in combination, net long or short.

Spot-month limits. The spot-month is defined for each Core Referenced Futures Contract generally as the month when the futures contract reaches maturity and becomes deliverable. The spot-month limit applies separately to physical-delivery Referenced Contracts and cash-settled Referenced Contracts (except for cash-settled NYMEX Henry Hub Natural Gas Contracts).[1] A trader's spot-month positions in a physical-delivery Referenced Contract may not be netted against cash-settled positions in the same Referenced Contract.

The proposed position limit rules would have set spot-month limits for cash-settled contracts at five times the level for physical-delivery contracts, so long as a person held no physical-delivery contracts. In setting spot-month limits at the same level for physical-delivery and cash-settled contracts, the CFTC cited concerns that permitting a trader to hold a larger position in look-alike cash-settled contracts could provide an incentive for price manipulation or inhibit price discovery.

The levels of the initial spot-month limits, specified in Appendix A to the rules, will become effective for all Referenced Contracts from 60 days after the effective date of rules further defining the term "swap" (the "**Effective Date**") until January 1 of the second year thereafter, when they will be set at 25% of the estimated deliverable supply.

Non-spot-month limits. The rules impose both single-month and all-months-combined non-spot-month limits, set at the same level. Unlike the proposed rules, which would not have permitted netting of futures and swaps positions, the final rules permit a trader to net all its positions in a particular Referenced Contract, including physical-delivery and cash-settled Referenced Contracts, for purposes of the non-spot-month limits.

The treatment of legacy Referenced Contracts (that is, those for which CFTC position limits currently apply) and non-legacy Referenced Contracts differs both in how non-spot-month position limit levels are derived and the implementation schedule. For legacy Referenced Contracts, the current non-spot-month position limits will apply until the Effective Date. Following the Effective Date, positions in legacy Referenced Contracts will be subject to the limits set out in the rule.

Non-spot-month position limits for non-legacy Referenced Contracts will be deferred until the CFTC has obtained or estimated 12 months' data on the Contracts. These levels must be reset one month after two years from when the initial limits take effect and then reset biennially, according to the following formula:

[1] Referenced Contracts on natural gas will be subject to both a cash-settled spot-month position limit and an aggregate limit covering both physical-settled and cash-settled contracts, which will be set at five times the spot-month position limits calculated under the estimated deliverable supply formula.

- 10% of the first 25,000 contracts of all-months-combined aggregated open interest (calculated as the sum of futures open interest, cleared swaps open interest, and uncleared swaps open interest);
- 2.5% thereafter.

Aggregation Standards

As under current rules, position limits apply 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 final rules also maintain the requirement for a person to aggregate positions or accounts in which the person has a 10% or greater ownership interest, with exceptions for passive ownership as a limited partner or other types of similar ownership, subject to specified conditions.

The final rules also require a person that holds or controls trading in accounts or pools with identical trading strategies, including passively managed index funds, to aggregate all such accounts or positions. A futures commission merchant (“**FCM**”) must aggregate positions held by it and 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, its officers, partners, or employees, or the FCM’s affiliates, unless a trader other than the FCM or the affiliate directs trading in the account and the FCM or the affiliate maintains only a minimum level of supervision over the account.

Exemptions from the aggregation requirement. The CFTC largely retained the “independent account controller” exemption from the aggregation requirement as it currently exists under the CFTC’s position limits rule. Under the exemption, a commodity pool operator (“**CPO**”) or commodity trading advisor (“**CTA**”) (whether or not required to register with the CFTC), a bank or trust company, or any of their separately organized affiliates (“**Eligible Entities**”) need not aggregate client accounts for which:

- the Eligible Entity has authorized an independent account controller to control all trading decisions without the Eligible Entity’s day-to-day direction;
- the Eligible Entity maintains only such minimum control over the independent account controller consistent with its fiduciary responsibilities and as necessary to supervise the trading done on its behalf; and
- the Eligible Entity files with the CFTC to claim the exemption.

The exemption is not available for spot-month positions in physical-delivery Referenced Contracts. The independent account controller exemption applies only to *client* positions; proprietary positions of an Eligible Entity must be aggregated.

Bona Fide Hedging Transactions or Positions

As required by Dodd-Frank, the final rules exempt positions and transactions that qualify as bona fide hedging transactions, under a new statutory definition, from the position limits. This exemption is limited to hedging of physical commodity positions or transactions; financial hedging and risk management are *not* exempt as bona fide hedging. The exemption for bona fide hedging is narrower than under existing CFTC position limit rules in that it is limited to transactions that represent a substitute for an actual cash market transaction, does not recognize “non-enumerated” hedges, and will not be construed to permit risk management positions. The new bona fide hedging definition applies only to agricultural and exempt commodities; existing CFTC regulation 1.3(z) is retained for excluded commodities.

For a position or transaction in a Referenced Contract to qualify as a bona fide hedge, it must meet the general criteria for a hedging transaction *and* be one of eight types of enumerated hedging transactions or positions *or* qualify as a "pass-through swap" or positions taken in connection with a pass-through swap. Each of these conditions is described below.

General criteria for hedging transactions. The general criteria for a bona fide hedging transaction are that a transaction or position must represent a substitute for a transaction in a "physical marketing channel" made or to be made that is economically appropriate to reduce risk in the conduct of a commercial enterprise and that arises from the change in value of specified assets, liabilities, or services. These criteria generally would not encompass transactions to hedge financial assets or contracts because they would not represent a substitute for a transaction in a physical marketing channel.

Enumerated hedging transactions. The final rule provides for eight types of enumerated hedging transactions. These include, among others, transactions designed to offset positions, or sales of positions, in physical commodities, anticipated merchandising hedges, anticipated royalty hedges, service hedges, and cross-commodity hedges.

Pass-through swaps and offsets. A swap, if it is entered into with a counterparty for whom the transaction would qualify as a bona fide hedge (a "**pass-through swap**"), would be deemed to be a bona fide hedge, but only to the extent that the pass-through swap is itself hedged by positions in Referenced Contracts. Positions or transactions in Referenced Contracts to hedge a pass-through swap would also be deemed bona fide hedges. A person relying on these provisions to exceed a position limit must obtain a written representation from its counterparty that the swap qualifies in good faith as a bona fide hedging transaction under the rules applicable to the counterparty.

Exemptive relief for particular hedging practices. The new definition of bona fide hedging would require affirmative action by the CFTC to approve a non-enumerated position or transaction as a bona fide hedge; specifically, a person would need to seek exemptive relief from the CFTC for such treatment. Under existing CFTC rules, a person can request the CFTC to recognize a non-enumerated transaction as a bona fide hedge by filing with the CFTC; upon filing, the person may treat the transaction as a bona fide hedge unless the CFTC determines otherwise. The change requiring affirmative CFTC action was a source of controversy among the Commissioners in considering the final rules. Commissioners Sommers and O'Malia expressed the view that this approach likely would increase uncertainty and unnecessarily limit the availability of legitimate hedging transactions.

Pre-Existing Positions

Pre-existing positions, entered into in good faith, are not subject to position limits, except spot-month limits. A trader's pre-Effective Date positions will be aggregated, however, with post-Effective Date positions in determining whether the trader has exceeded position limits established by the final rules. The CFTC made clear that the exemption for pre-existing positions is not available to an index fund that "rolls" pre-existing positions forward by entering into new positions after the Effective Date. However, swap positions entered into in good faith before the relevant effective date may be netted with post-effective date swaps.

Other Noteworthy Aspects of the Final Rules

We note several other aspects of the final rules that market participants should consider in assessing the implications of the final rules on their business and the types of measures that may need to be taken to ensure compliance with the rules.

- Traders who hold or control positions in energy and metals Referenced Contracts will be subject to CFTC reporting requirements (termed "position visibility" reporting) if their positions, net long or short including bona fide hedging positions, exceed levels set out in the rule. These levels are approximately 50% to 60% of the projected aggregate position limits for most Referenced Contracts. The report must include positions held at or above the specified levels, the date in a calendar quarter on which the largest net positions above the levels were held, and gross long and short positions separately for futures, options, and swaps (cleared and uncleared). The reports, like those currently made under the CFTC's large trader reporting program, will be confidential.

- The final rules require designated contract markets and swap execution facilities on which Referenced Contracts trade to adopt and enforce rules limiting positions in Referenced Contracts to levels no less strict than those established by CFTC rule; these exchanges may set more strict position limit levels. The rules also set forth standards for acceptable position limits for contracts and position accountability rules for other than Referenced Contracts.
- The position limits will apply on an intraday basis, not merely at the end of each trading day.
- The rules put in place various additional compliance and reporting requirements, including reporting requirements upon exceeding position limit levels and filing and reporting requirements in connection with claiming aggregation and bona fide hedging exemptions.

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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