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CFTC Proposes New Position Limits and Aggregation Rules for Futures and Swaps

On November 5, 2013, the Commodity Futures Trading Commission (the "CFTC" or "Commission") proposed new position limits rules that establish speculative position limits in 28 core referenced futures contracts traded pursuant to the rules of a designated contract market ("DCM"), as well as futures, options and swaps that are economically equivalent to such contracts. Separately, the CFTC proposed rules providing exemptions from aggregation of contracts, subject to position limits.

The proposed rules for speculative position limits and exemptions from aggregation follow a decision by the Commission to drop its appeal of a United States District Court for the District of Columbia ruling last year that vacated the Commission's previously adopted final rules. Adopted on October 18, 2011, those final rules were struck down after a successful challenge by two industry associations.

Comments on each proposal must be received on or before the date that is 60 days after date of publication in the Federal Register.

Position Limits

Which contracts does the proposal affect? What are the proposed limits?

The proposed rules establish speculative position limits for 28 core referenced futures contracts, as well as futures, options and swaps that are economically equivalent to such contracts (collectively, the "Referenced Contracts"). The proposed rules specifically exclude from the definition of Referenced Contract a guarantee of a swap, a basis contract and a commodity index contract.

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The 28 core referenced futures contracts include the following contracts, by commodity category[1]:

- **Nine "legacy" agricultural contracts**[2]: (1) CBOT Corn (C) – 600/53,500; (2) CBOT Oats (O) – 600/1,600; (3) CBOT Soybeans (S) – 600/26,900; (4) CBOT Soybean Meal (SM) – 720/9,000; (5) CBOT Soybean Oil (BO) – 540/11,900; (6) CBOT Wheat (W) – 600/16,200; (7) ICE Futures U.S. Cotton No.2 (CT) – 300/8,800; (8) KCBT Hard Winter Wheat (KW) – 600/6,500; and (9) MGEX Hard Red Spring Wheat (MWE) – 600/3,300.
- **Ten non-"legacy" agricultural contracts**: (1) CME Class III Milk (DA) – 1,500/3,400; (2) CME Feeder Cattle (FC) – 300/3,000; (3) CME Lean Hog (LH) – 950/9,400; (4) CME Live Cattle (LC) – 450/12,900; (5) CBOT Rough Rice (RR) – 600/2,200; (6) ICE Futures U.S. Cocoa (CC) – 1,000/7,100; (7) ICE Futures U.S. Coffee C (KC) – 500/7,100; (8) ICE Futures U.S. FCOJ-A (OJ) – 300/2,900; (9) ICE Futures U.S. Sugar No. 11 (SB) – 5,000/23,500; and (10) ICE Futures U.S. Sugar No. 16 (SF) – 1,000/1,200.
- **Four energy contracts**: (1) NYMEX Henry Hub Natural Gas (NG) – 1,000/149,600; (2) NYMEX Light Sweet Crude Oil (CL) – 3,000/109,200; (3) NYMEX New York Harbor Gasoline Blendstock (RB) – 1,000/11,800; and (4) NYMEX New York Harbor Heating Oil (HO) – 1,000/16,100.
- **Five metal contracts**: (1) COMEX Copper (HG) – 1,200/5,600; (2) COMEX Gold (GC) – 3,000/21,500; (3) COMEX Silver (SI) – 1,500/6,400, (4) NYMEX Palladium (PA) – 650/5,000; and (5) NYMEX Platinum (PL) – 500/5,000.

The proposed rules list *spot month* [3], *single month*, and *all-months-combined* position limits for the Referenced Contracts.

The proposed rules set *spot month* position limits for Referenced Contracts at existing DCM-levels for the core referenced futures contracts. These limits generally correspond to 25 percent of estimated deliverable supply (DCMs already set spot month position limits based on their own estimates of deliverable supply). These limits are applied separately for positions in the physical-delivery and cash-settled Referenced Contracts.

The Commission proposes that initial spot month position limits be based on the limit levels currently in place at DCMs. However, the Commission is considering two alternative proposals. The first alternative sets the initial spot month position limits based on estimated deliverable supplies submitted by the CME Group, a prominent derivatives and futures exchange. The second alternative sets the initial spot month position limits based on: (i) the recommended level of the spot month limit as submitted by each DCM listing a core referenced futures contract (if lower than 25 percent of estimated deliverable supply); (ii) a level corresponding to 25 percent of estimated deliverable supply; or (iii) the limit levels currently in place at DCMs, at the Commission's discretion. The Commission proposes to reset spot month position limits at least every two years.

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[1] The position limits that follow each core referenced futures contract is the proposed *initial* (spot month/single-month and all-months-combined) limits for such contracts.

[2] These agricultural contracts are referred to as "legacy" contracts because speculative position limits have historically applied to these contracts.

[3] The term "spot month" does not refer to a month of time. Rather, the term refers to the trading period immediately preceding the delivery period for a physical-delivery futures contract as well as for any cash-settled swaps and futures contracts that are linked to the physical-delivery contract.

The non-spot month position limits would apply to positions a trader may have in *all contract months combined* or in a *single contract month*. For each Referenced Contract, these limits are set at 10 percent of open interest in the first 25,000 contracts and 2.5 percent thereafter. Open interest used in determining non-spot month position limits is based on futures open interest, cleared swaps open interest and uncleared swaps open interest. The Commission proposes to reset non-spot month position limits at least every two years.

What makes a futures, option or swap contract 'economically equivalent' to a core referenced futures contract?

The proposed speculative position limits generally apply to the 28 core referenced futures contracts identified above. However, the limits also apply to contracts that are 'economically equivalent' to such core referenced futures contracts. A futures, option or swap contract may be 'economically equivalent' to a core referenced futures contract where, on a "futures-equivalent[4]" basis with respect to that particular core referenced futures contract, it is: (i) directly or indirectly linked to, including being partially or fully settled on, or priced at a fixed differential to, the price of the particular core referenced futures contract or (ii) directly or indirectly linked to, including being partially or fully settled on, or priced at a fixed differential to, the price of the same commodity underlying the particular core referenced futures contract for delivery at the same location or locations as specified in that particular core referenced futures contract.

Will there be any grandfathering for pre-existing positions?

Yes, the proposed rules generally exempt from *non-spot month* position limits any Referenced Contract position acquired by a person in good faith prior to the effective date of such limit (but do not exempt any increases after the effective date). This exemption does not apply to *spot month* position limits.

The Commission also proposes to grandfather pre-enactment swaps[5] and transition swaps[6] entered into before the effective date for speculative position limits, but only for the purpose of complying with any non-spot month position limit.

How does the bona fide hedging exemption work?

Bona fide hedging has long been recognized by the Commission as a form of trading that does not pose a significant risk to the manipulation or abuse of market prices and in general addresses the commercial risk management needs of market participants. Importantly, positions that qualify for bona fide hedging relief are not counted for speculative position limits purposes.

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4 "Futures-equivalent" is defined in the proposed rules to mean "(1) an option contract, whether an option on a future or an option that is a swap, which has been adjusted by an economically reasonable and analytically supported risk factor, or delta coefficient, for that option computed as of the previous day's close or the current day's close or contemporaneously during the trading day, and (2) a swap which has been converted to an economically equivalent amount of an open position in a core referenced futures contract."

5 Swaps entered into before July 21, 2010, the terms of which have not expired as of that date. July 21, 2010 marks the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

6 Swaps entered into after July 21, 2010 but before the applicable compliance date for such swaps as set forth in the Commission's final swap data reporting rules.

The proposed bona fide hedging exemption covers: (i) general requirements for all hedges; (ii) hedges of an excluded commodity; (iii) requirements for hedges of a physical commodity; (iv) requirements for cross-commodity hedges; and (v) certain enumerated hedges.

General Requirements

In order for a position to qualify for the exemption, the following conditions must be met: (i) the purpose of the position must be to offset price risks incidental to commercial cash operations (the "incidental test") and (ii) the position must be established and liquidated in an orderly manner in accordance with sound commercial practices (the "orderly trading requirement").

The Commission intends the proposed incidental test to be a requirement that the risks offset by a commodity derivative contract hedging position must arise from commercial cash market activities. The proposed orderly trading requirement is intended to impose on bona fide hedgers a duty of ordinary care (a facts and circumstances test) when entering, maintaining and exiting the market in the ordinary course of business and in order to avoid as practicable the potential for significant market impact in establishing, maintaining or liquidating a position in excess of position limitations.

Hedges of an Excluded Commodity

The proposed definition of bona fide hedging position for contracts in an excluded commodity (generally, financial and occurrence-based commodities) requires that the position is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise (the "economically appropriate" test) and is either (i) an enumerated hedge (as discussed below) or (ii) recognized as a bona fide hedging position by a DCM or Swap Execution Facility that is a trading facility, subject to certain conditions.

Physical Commodity Hedges

The proposed rules also provide exemptions for bona fide hedging positions for futures and option contracts on physical commodities listed by DCMs as well as swaps that are economically equivalent to futures contracts and direct-access linked Foreign Board of Trade futures contracts that are economically equivalent to futures contracts listed by DCMs. The proposed rules recognize as bona fide a position in any futures, option or swap contract in a commodity (a "commodity derivative contract") that: (i) represents a substitute for positions taken or to be taken at a later time in the physical marketing channel (the "temporary substitute" test); (ii) is economically appropriate to the reduction of risks (the "economically appropriate" test); and (iii) arises from the potential change in value of assets, liabilities or services (the "change in value" requirement), provided the position is for an enumerated hedge (as discussed below) or is a pass-through swap offset or pass-through swap position.

Cross-Commodity Hedges

The proposed cross-commodity hedging provisions apply to all enumerated hedges (as discussed below) as well as to pass-through swaps. The proposed rules condition cross-commodity hedging on: (i) whether the fluctuations in value of the commodity derivative contract (or the commodity underlying the commodity derivative contract) are "substantially related" to the fluctuations in value of the actual or anticipated cash position or pass-through swap; and (ii) for positions in any physical-delivery commodity derivative contract,

that such hedges were not recognized in the five last days of trading in any particular futures contract (the "five-day rule").

Enumerated Hedges

Enumerated hedges are a non-exclusive list of hedges that automatically qualify as bona fide (still subject to the general requirements for bona fide hedges, as described above). The proposed rules include historically enumerated hedges[7], but also introduce unfilled anticipated requirements for resale by a utility, anticipated royalties and service contracts as enumerated hedges.

Financial Distress Exemptions

Although not considered a hedging exemption, the Commission also proposed to codify its prior exemptive practices for certain financial distress situations, which include a default or potential bankruptcy of a customer at a futures commission merchant ("FCM"). The Commission explained that it has historically provided for an exemption from speculative position limits in these types of situations to avoid sudden liquidations that could potentially reduce liquidity, disrupt price discovery or increase systemic risk.

Petition for Relief

It is expected that market participants will also be able to petition the CFTC for exemptive relief for any legitimate "risk reducing" hedging transaction to qualify as a bona fide hedging transaction, or to seek interpretive guidance from CFTC staff on whether certain of their hedging strategies would qualify as bona fide hedging. In addition, the final rule is expected to contain exemptions for positions established in good faith prior to the effective date of the initial limits established by the final rule.

Aggregation Rules

Generally, a person must aggregate all positions (1) under such person's control or (2) beneficially owned by such person. Positions may be disaggregated to the extent there is an available exemption. The Commissions proposed rule address the exemptions available to market participants and are described below. Market participants claiming an exemption are subject to call by the Commission to demonstrate that the conditions of the exemption apply.

What are the aggregation rules around 10 percent and 50 percent ownership?

The proposed rules generally provide that persons with either an ownership or an equity interest in an account or position of less than 10 percent need not aggregate such positions, and persons with a 10 percent or greater ownership interest would generally be required to aggregate the account or positions. However, the proposed rules establish a notice filing procedure, effective upon submission, to permit a person with either an ownership or an equity interest in an owned entity of 50 percent or less to disaggregate the positions of an owned entity.

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[7] (A): Hedges of inventory and cash commodity purchase contracts; hedges of cash commodity sales contracts; hedges of unfilled anticipated requirements for same cash commodity; hedges by agents; and (B): Hedges of unsold anticipated production; hedges of offsetting unfixed-price cash commodity sales and purchases; hedges of offsetting unfixed-price cash commodity sales and purchases; where hedges in clause (B) are subject to the five-day rule.

The notice for disaggregation must include a showing that the person filing for disaggregation relief and the owned entity: (i) do not have knowledge of the trading decisions of the other; (ii) trade pursuant to separately developed and independent trading systems; (iii) have and enforce written procedures to preclude the one entity from having knowledge of, gaining access to, or receiving data about, trades of the other; (iv) do not share employees that control the owned entity's trading decisions, and the employees of the owned entity do not share trading control with such persons; and (v) do not have risk management systems that permit the sharing of trades or trading strategies with the other.

Finally, the proposed rules permit a person with a greater than 50 percent ownership of an owned entity to apply to the Commission for relief from aggregation on a case-by-case basis.

How will the independent account controller exemption to aggregation be affected?

The Commission has proposed a modified version of its existing independent account controller exemption to aggregation ("IAC" or "IAC Exemption"). This exemption views separately-run trading books independently. Generally, for commodity pool operators and investment advisers, this means that they are not required to aggregate positions of subsidiaries or underlying managers in relation to the investment vehicles that they operate or advise. However, the Commission did reaffirm the position that the IAC exemption is limited to client positions, which means such exemption is available only to the extent one trades professionally for others, and does not extend to proprietary positions in accounts that a trader owns.

Importantly, the IAC exemption is no longer self-effectuating. Instead, a firm relying on the exemption is required to make a notice filing, which would be effective upon filing and thus not require any pre-approval from the CFTC.

To qualify for the exemption, each IAC must trade independently of the firm relying on the exemption, as well as other IACs, and have no knowledge of trading decisions by any other IAC. The determination of whether a trader exercises independent control over the trading decisions of the customer discretionary accounts or trading programs within the meaning of the IAC exemption is decided case-by-case based on the particular underlying facts and circumstances.

What is the exemption for information sharing?

The proposed rules provide that a person need not aggregate the positions or accounts of an owned or controlled entity if the sharing of information associated with such aggregation creates a *reasonable risk* that either person could violate state or federal law or the law of a foreign jurisdiction, or regulations adopted thereunder, provided that such person (i) does not have actual knowledge of the information and (ii) has filed a prior notice that includes a written memorandum of law (which may be prepared by an employee of the person or its affiliates) explaining in detail the basis for relief.

Are there any exemptions for FCMs, broker-dealers and underwriters?

Yes, the proposed rules contain aggregation exemptions for: (i) FCMs and their affiliates (which, subject to certain conditions, need not aggregate positions held in a discretionary account, or in an account that is part of, or participates in, or receives trading advice from a customer trading program of an FCM or any

of the officers, partners, or employees of such FCM or of its affiliates); (ii) broker-dealers (which need not aggregate the positions or accounts of an owned entity if the broker-dealer does not have greater than a 50 percent ownership or equity interest in the owned entity and the ownership or equity interest is based on the ownership of securities 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); and (iii) underwriters (which need not aggregate the positions or accounts of an owned entity if the ownership or equity interest is based on the ownership of securities constituting the whole or a part of an unsold allotment to or subscription by the underwriter as a participant in the distribution of such securities by the issuer or by or through such underwriter). Each of these exemptions would require a notice filing, effective upon filing.

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