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Derivatives Alert

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CFTC Proposes New Rules on Position Limits

On January 30, 2020, the Commodity Futures Trading Commission (CFTC or Commission) voted 3-2 to issue a proposed rulemaking on speculative position limits (the Proposal).[1] The Proposal would apply spot month-only[2] federal speculative position limits — based on a Commission finding that they are necessary — to a wider range of contracts than the nine agricultural contracts currently subject to federal limits[3] and provide additional exemptions from those limits, including expanded bona fide hedge exemptions. By abandoning the position that the 2010 Dodd-Frank amendments to the Commodity Exchange Act (CEA) mandated that the Commission impose limits on all physical commodity futures contracts and economically equivalent swaps (and thus obviated the need for a "necessity" finding), the Proposal is a significant departure from the CFTC's previous attempts at implementing new position limits rules.

Commissioners Dan M. Berkovitz and Rostin Behnam expressed strong — and colorful — reservations about the Proposal. Paraphrasing Clint Eastwood's line from the movie "Magnum Force," Commissioner Berkovitz noted that the Proposal — by requiring a "necessity" finding and thereby making it more difficult to put limits on excessive speculative trading — does not meet Congress's directive that market participants "got to know their limitations." Commissioner Behnam for his part invoked the movie "Ford v Ferrari" to convey his concern that the Proposal is not aiming for the "perfect lap," but rather has set the CFTC "on a course where it will remain perpetually in the draft" because of the lead role the Proposal would provide to the futures exchanges (as described further below) in defining new bona fide hedge exemptions.

The CFTC is withdrawing all of its previous position limits proposals, and comments on the new Proposal are due April 29, 2020.

Background

As amended by the Dodd-Frank Act, CEA Section 4a(a)(1) directs the CFTC to establish limits on speculative positions "as the Commission finds are necessary" to prevent the harms caused by excessive speculation. CEA Section 4a(a)(2)(A), in turn, requires the CFTC to establish speculative position limits "as appropriate, other than bona fide hedge positions."

[1] See press release, "CFTC Approves Two Proposed Rules at January 30 Open Meeting," CFTC (Jan. 30, 2020).

[2] "Spot month" refers to the nearest month that a futures contract matures and becomes deliverable.

[3] See 17 C.F.R. § 150.2.

In 2011, the CFTC adopted new position limits rules based on its interpretation that CEA Section 4a unambiguously required it to establish position limits without first finding that those limits are necessary, with discretion to determine the "appropriate" levels for each limit. A federal district court disagreed that the statute clearly imposed a mandate and vacated the rules the following year, directing the CFTC to apply its experience and expertise to interpret whether CEA Section 4a requires an antecedent finding by the Commission that a position limit is necessary before imposing the limit.[4]

In the wake of the district court's ruling, the CFTC issued a new position limits proposal in 2013, a supplemental proposal in 2016, and a re-proposal in 2016. In all of these proposals, the CFTC took the position that CEA Section 4a required it to establish position limits even in the absence of a finding that the limits were "necessary." None was finalized.

In the latest Proposal, the CFTC reversed its position, and now concludes that the best interpretation of CEA Section 4a is that Congress requires an antecedent Commission finding that a position limit is necessary before it may be imposed. Based on that interpretation, and a finding of necessity with respect to 25 commodity futures markets, the CFTC proposes position limits in the spot month on 16 additional commodity derivative contracts (beyond the nine "legacy" agricultural commodity futures that are currently subject to federal limits).

Proposed Position Limits

The key features of the proposed position limits include:

- For the spot month, federal position limits set at or below 25 percent of deliverable supply would apply to the following "referenced contracts":
  - 25 physically-settled "core referenced futures contracts" (CRFC);[5]
  - cash-settled futures and options on futures that include for settlement the price of a CRFC or the price of the same commodity underlying the CRFC; and
  - "economically equivalent swaps" that have identical "material" specifications, terms and conditions to a CRFC or its linked cash-settled futures or options on futures.[6]
- For the non-spot month, federal position limits would apply only to the nine legacy agricultural contracts that are currently subject to non-spot month federal limits. However, exchanges would still be required to establish exchange-set position limits and/or position accountability levels in the non-spot months for the non-legacy agricultural, metals and energy CRFCs.
- Federal position limits would not apply to a location basis contract, a commodity index contract, any guarantee of a swap, or a trade option that meets the requirements of CFTC Rule 32.3.
- For the spot month, positions in physically-settled contracts may not be netted with positions in linked cash-settled contracts.

Proposed Exemptions

Bona fide hedge exemption

The Proposal would define a "bona fide hedging position" as a position that:

- represents a substitute for transactions made or to be made, or positions taken or to be taken, at a later time in a physical marketing channel (meeting the "temporary substitute test");
- is economically appropriate to the reduction of price risks in the conduct and management of a commercial enterprise (meeting the "economically appropriate test"); and
- arises from the potential change in value of actual or anticipated assets, liabilities, or services (meeting the "change in value requirement").

Significantly, under the proposed temporary substitute test, positions entered into for "risk management purposes" would no longer be recognized as bona fide hedges, unless the position offsets risk from a swap involving a counterparty with bona fide hedging needs. The CFTC noted that the Proposal would

[4] See *Int'l Swaps & Derivatives Ass'n v. U.S. Commodity Futures Trading Comm'n*, 887 F. Supp. 2d 259 (D.D.C. 2012).

[5] Nine of these are the "legacy" agricultural contracts currently subject to federal position limits. The 16 contracts newly subject to proposed limits include seven additional agricultural contracts, four energy contracts and five metals contracts.

[6] The Proposal explains that material specifications, terms and conditions are those that drive the economic value of a swap, such as the underlying commodity, maturity or termination dates, settlement type (cash v. physical), or delivery specifications for physically-delivered swaps. Material terms do not include delivery dates diverging by less than one calendar day (less than two calendar days for natural gas swaps), post-trade risk management (such as clearing or margin), lot size or notional amount.

Under the Proposal, market participants would have the discretion to determine whether the instrument they trade is an "economically equivalent swap" as long as they make a "reasonable, good faith effort" in making that determination, but the CFTC could always make its own determination and override market participants' conclusion.

provide some measures to mitigate the impact of eliminating the risk management exemption, such as applying federal non-spot month limits only to the nine legacy agricultural contracts and raising the non-spot month limits for those contracts.

Market participants with bona fide hedging positions could claim an exemption for those positions in two ways:

- The Proposal would provide a list of enumerated bona fide hedging transactions and automatically exempt from applicable federal position limits any market participant that follows specific practices outlined in that list.[7]
  - Notably, the list includes hedges of anticipated merchandising, provided that (i) the derivative position does not exceed in quantity 12 months' worth of anticipated merchandising needs and (ii) the person claiming the exemption is a merchant who can demonstrate the historical practice of purchasing and selling the underlying commodity that is anticipated to be merchandised or otherwise show relevant activities in the physical marketing channel.
  - The Proposal would no longer apply the "five-day rule," whereby certain enumerated hedging positions in physical delivery contracts are not recognized as bona fide hedges when the position is held during the last five days of trading during the spot month, to enumerated bona fide hedging practices for purposes of federal position limits. The exchanges would still be able to impose the five-day rule in connection with their own exchange-set limits.
  - The market participant may still need to apply to the relevant exchange for an exemption from exchange-set limits.
  - The Proposal explicitly states that the CFTC would be open to expanding the list of enumerated hedges "as it becomes more comfortable with evolving hedging practices."
- For non-enumerated bona fide hedging transactions (those that the CFTC has not already defined as meeting the criteria for bona fide hedging), market participants can either:
  - apply directly to the CFTC for an exemption (and separately to the relevant exchange); or
  - apply to the relevant exchange for an exemption from *both* federal and exchange-set limits (and only with respect to that particular exchange's limits). If the exchange approves the application, the exemption would also be valid for purposes of federal limits unless a majority of Commissioners object within 10 business days (or two business days in the case of sudden or unforeseen bona fide hedging needs).[8]

While the Proposal would generally require market participants to obtain approval to exceed limits *before* taking on the excess position, it would permit those with sudden or unforeseen hedging needs to file a request for an exemption within five business days *after* exceeding the limit. If the request is rejected, the market participant would not be subject to a position limit violation if the participant reduces its position within a commercially reasonable amount of time.

The Proposal would also eliminate the requirement to submit monthly cash-market reporting on Forms 204/304 related to bona fide hedging positions. Instead, the exchanges would collect and make available to the CFTC cash-market information needed to assess whether any such position is a bona fide hedge.

Conditional spot month limit exemption for certain natural gas positions

The Proposal offers unique treatment for natural gas contracts. It would generally set a 2,000 NYMEX Henry Hub Natural Gas (NYMEX NG) equivalent-size contract spot month limit, such that a market participant could only hold up to 2,000 contracts net long or net short across exchanges/over-the-counter (OTC) in *physically-settled* natural gas referenced contract(s) *and* another 2,000 contracts net long or net short across exchanges/OTC in cash-settled natural gas referenced contract(s). The proposed federal limit would double the current exchange-set spot month limit of 1,000 contracts (no federal limit on energy contracts exists today).

However, if a market participant does *not* hold or control any positions during the spot month in the physically-settled NYMEX NG core referenced futures contract, the participant would be permitted to hold a much larger number of cash-settled contracts: up to 10,000 NYMEX NG equivalent-size contracts net long or net short *per exchange*, plus an additional 10,000 NYMEX NG futures equivalent-size contracts in economically equivalent swaps in total across all swap execution facilities and OTC.

[7] The proposed list includes the following: (1) hedges of unsold anticipated production, (2) hedges of offsetting unfixed-price cash commodity sales and purchases, (3) hedges of anticipated mineral royalties, (4) hedges of anticipated services, (5) cross-commodity hedges, (6) hedges of inventory and cash commodity fixed-price purchase contracts, (7) hedges of cash commodity fixed-price sales contracts, (8) hedges by agents, (9) offsets of commodity trade options, (10) hedges of unfilled anticipated requirements and (11) hedges of anticipated merchandising.

[8] In the 2016 re-proposal, the CFTC would have allowed exchanges to recognize non-enumerated bona fide hedges for purposes of federal position limits without any Commission review. In the new Proposal, the CFTC explains that the 10-day review period would be required because the 2016 approach "may not have retained enough authority with the Commission under case law on sub-delegation of agency decision making authority." As noted above, Commissioner Behnam views the current Proposal insufficient to ensure Commission control of the recognition of non-enumerated bona fide hedge exemptions. Commissioner Berkovitz similarly noted that while the exchanges are well suited for determining whether a particular position constitutes a bona fide hedge as defined by the CFTC, the Commission alone should initially determine what types of positions constitute bona fide hedges through notice and comment rulemaking.

Other exemptions

Other proposed exemptions include:

- an exemption for spread transactions, which include calendar spreads, inter-commodity spreads, quality differential spreads, processing spreads (such as energy "crack" or soybean "crush" spreads), product or by-product differential spreads, or futures-option spreads;
- a financial distress exemption for a company that takes over the positions of another company in financial distress and as a result exceeds federal position limits; and
- an exemption for legacy swaps such as:
  - any swap entered into before enactment of the Dodd-Frank Act, which has not expired as of the date of enactment of the Dodd-Frank Act ("pre-enactment swap"); and
  - any swap entered into during the period starting July 22, 2010, and ending 60 days after the publication of a final federal position limits rulemaking in the Federal Register, which has not expired as of that date ("transition period swap").

The CFTC has been down this road several times since the Dodd-Frank amendments to the CEA gave new focus to position limits.[9] Proposals on position limits have always provoked controversy, and the current Proposal, while less ambitious in its scope than previous versions, is unlikely to be immune. CFTC Chairman Heath Tarbert appears determined that this Proposal not meet the same fate of its predecessors, which were either invalidated or never adopted. While acknowledging the decade-long history and controversies around previous proposals, Chairman Tarbert stressed that the new rule set "offers the pragmatic, workable solution" that strikes the right balance.

[9] The Dodd-Frank Act directed the CFTC to establish position limits for exempt commodities (such as energy commodities and metals) within 180 days and for agricultural commodities within 270 days after the Act's enactment (which was July 21, 2010). See 7 U.S.C. § 6a(a)(2)(B).