Client Advisory

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Financial Services

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CFTC Proposes Substantial Amendments to Speculative Position Limits

The Commodity Futures Trading Commission has issued proposed rules that would substantially modify the position limit and position accountability rules that currently apply to the trading of various agricultural, energy and metals derivative products. The proposed rules were originally considered at the CFTC's public meeting on December 16, but were not brought to a vote at that time due to concerns expressed by the Commissioners. At the January 13 public meeting, the Commissioners voted in favor of publishing the proposed rules; however, Commissioner Sommers dissented, while Commissioners Dunn and O'Malia both expressed reservations about the adoption of the proposed rules.

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) requires the CFTC to establish federal speculative position limits for both "exempt commodities" (including energy and metals products) and "agricultural commodities" (which would include the agricultural products for which the CFTC has historically set position limits, as well as an expanded range of agricultural and "soft" commodities). To implement these new requirements, the CFTC proposes to withdraw its Part 150 Regulations, which set out the CFTC's current position limit and aggregation policies, and replace them with a new Part 151. Among the changes that would be effected by the CFTC's proposed regulations are the following:

- Phased implementation of aggregate speculative position limits for derivatives (including futures, options and swaps) on specified commodities across trading venues.
- Modifications to the "bona fide hedging" exemption from position limits, including its applicability to swap dealers.
- Expanded position visibility and aggregation requirements, including the elimination of the "independent account controller" exemption.

New Position Limits

As revised by Dodd-Frank, the Commodity Exchange Act (CEA) mandates that the CFTC establish federal position limits for futures and options contracts traded on designated contract markets (DCMs) within 180 days (in the case of contracts on exempt commodities) or 270 days (in the case of contracts on agricultural commodities) after Dodd-Frank's enactment. In addition, the Dodd-Frank amendments require the CFTC to establish aggregate position limits for other derivatives on such commodities that would include, in addition to the futures and options contracts described above: (i) swaps that are traded on a DCM or swap execution facility (SEF); (ii) swaps that are economically equivalent to DCM-traded futures or options contracts that are subject to position

If you would like assistance in commenting on the Proposed Amendments or more information about the matters discussed in this Client Advisory, please contact your Katten Muchin Rosenman LLP attorney or any of the following members of Katten's **Financial Services Practice**.

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limits; (iii) swaps not traded on a DCM or SEF, but which are determined to perform or affect a "significant price discovery function"; and (iv) foreign board of trade (FBOT) contracts that are price-linked to a DCM or SEF contract and made available via direct access from within the United States.

To implement this expanded mandate under Dodd-Frank, the CFTC proposal identifies 28 "core" physical delivery futures contracts in proposed Regulation 151.2 ("core referenced futures contracts"),[1] and would apply aggregate limits on a futures equivalent basis[2] across all derivatives that are (i) directly or indirectly linked to the price of a core referenced futures contract, or (ii) based on the price of the same underlying commodity for delivery at the same delivery location as that of a core referenced futures contract, or another delivery location having substantially the same supply and demand fundamentals (such derivative products are collectively defined as "referenced contracts").[3] In response to concerns that the CFTC lacks sufficient data about the physical commodity swap markets to implement aggregate non-spot-month position limits for all markets, the CFTC proposal contemplates a phased implementation of the new position limit requirements for referenced contracts, as further described below.[4]

Spot-Month Limits. The CFTC proposes to impose aggregate spot-month position limits for physical delivery referenced contracts at a level equal to 25% of estimated deliverable supply, consistent with current CFTC policy. During the initial implementation phase, the limits for referenced contracts would be set at the level determined by the applicable DCM to be equal to 25% of estimated deliverable supply, and would be reset annually. In the second phase of implementation, the limit levels would be based upon the CFTC's determination of estimated deliverable supply (which could be based on DCM-provided estimates or the CFTC's own estimates).

For cash-settled contracts, the CFTC proposal would implement a conditional spot-month limit equal to five times the spot-month limit for the corresponding physically settled contract. In order to qualify for the conditional limit, a trader must not hold (i) a position in excess of the applicable single-month (non-spot) position limit for such cash-settled contract; (ii) any spot-month position in the corresponding physically settled contract; or (iii) physical or forward commodity positions in the same commodity in the spot-month that exceed 25% of the estimated deliverable supply.

Non-Spot-Month Limits. Unlike spot-month limits, the CFTC does not propose to implement non-spot-month limits for referenced contracts during the initial implementation phase, but rather intends to implement such limits only as part of the second phase of implementation. Under the CFTC proposal, separate non-spot-month limits would be established for (i) DCM futures and options contracts (the "futures class") and (ii) cleared and uncleared swaps (the "swaps class"), as well as (iii) an aggregate limit across the futures and swaps classes. At both the class and aggregate levels, the single-month limit would be set at the same level as the all-months combined limit, and would be calculated as a percentage of overall open interest in the applicable referenced contracts. Specifically, the limits would be set at a level equal to (i) 10% of the first 25,000 contracts of average all-months combined aggregate open interest, and (ii) 2.5% of the average all-months combined aggregate open

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1 These core referenced futures contracts include: Chicago Board of Trade Corn, Oats, Rough Rice, Soybeans, Soybean Meal, Soybean Oil and Wheat; Chicago Mercantile Exchange Feeder Cattle, Lean Hogs, Live Cattle and Class III Milk; Commodity Exchange, Inc. Gold, Silver and Copper; ICE Futures U.S. Cocoa, Coffee C, FCOJ-A, Cotton No.2, Sugar No. 11 and Sugar No. 16; Kansas City Board of Trade Hard Winter Wheat; Minneapolis Grain Exchange Hard Red Spring Wheat; and New York Mercantile Exchange Palladium, Platinum, Light Sweet Crude Oil, New York Harbor No. 2 Heating Oil, New York Harbor Gasoline Blendstock and Henry Hub Natural Gas.

2 Guidance regarding the CFTC's proposed methodology for converting and aggregating swaps on a futures equivalent basis is available in Appendix A to the CFTC's proposed rulemaking on position reporting for physical commodity swaps, which is available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-27538a.pdf.

3 For contracts that are not subject to a federal limit under the CFTC proposal, trading facilities would generally be required to adopt limits based on the same methodology proposed by the CFTC with respect to referenced contracts, but would have the option to implement flat single-month or all-months-combined levels of 1,000 contracts for non-energy tangible commodities and 5,000 contracts for energy products and non-tangible commodities, or to utilize position accountability rules for major foreign currency contracts and certain excluded commodities.

4 The CFTC does not specify dates for either the implementation phases contemplated in its proposal; however, the proposal notes that the CFTC does not intend to adopt specific limits pursuant to the formulas set out in the proposed regulations until the first quarter of 2012 (unless the CFTC determines that there is sufficient data to implement certain limits at an earlier date).

interest in excess of 25,000 contracts. With respect to the agricultural commodities that are currently subject to CFTC position limits under CFTC Rule 150.2, the CFTC proposal would implement legacy limits equal to the current all-months-combined limits for such commodities, and would increase the corresponding single-month limit to equal the all-months-combined limit.

"Bona Fide Hedging" Exemption

Under the CFTC proposal, a new "bona fide hedging" exemption would be created under proposed CFTC Regulation 151.5, and referenced contracts would no longer be subject to the bona fide hedging provisions contained in CFTC Regulation 1.3(z).[5] The bona fide hedging exemption under the new rules would be largely consistent with that currently contained in Regulation 1.3(z), with the following exceptions:

- Under the proposed regulations, a position would be recognized as a bona fide hedge only if it represents a substitute for a cash market transaction. (Regulation 1.3(z) recognizes a position as a bona fide hedge if it *normally* represents such a substitute.)
- The proposed regulations would explicitly recognize positions established to reduce the risk of a swap position as bona fide hedges, provided that either (i) the counterparty to such swap position would have qualified for a bona fide hedging transaction exemption (i.e., on a "look through" basis), or (ii) the risk-reducing positions offset a swap that qualifies as a bona fide hedging transaction.

The CFTC proposal would establish new application, recordkeeping and reporting requirements for traders relying upon bona fide hedge exemptions. Unlike the position limit rules proposed by the CFTC in January 2010 for energy contracts, the bona fide hedging provisions in the new proposal do not include a "crowding out" provision, which would have limited the ability of a trader relying upon a bona fide hedge exemption or acting as a swap dealer to also establish speculative positions.

Revised Aggregation Requirements

The proposed Part 151 Regulations would also materially modify the position aggregation rules and exemptions currently embodied in the Part 150 Regulations. The CFTC proposal would continue the current practice of evaluating aggregation requirements on the basis of both ownership and control, requiring aggregation of all positions in accounts in which a trader either (i) holds a direct or indirect ownership interest of 10% or more, or (ii) controls trading, by power of attorney or otherwise. However, the CFTC's proposed regulations would apply aggregation requirements more aggressively to investors in pooled investment vehicles than is currently the case, presumptively requiring aggregation for pool investors who hold an interest of 10% or more in a pool (without regard to whether such investors are affiliates of the pool operator), unless disaggregation relief is available, and requiring aggregation by pool investors who hold an interest of 25% or more in a pool (without regard to whether the pool operator is registered or exempt from registration as a commodity pool operator) with no possibility of disaggregation. The CFTC proposal also would withdraw the "independent account controller" exemption that currently appears in the Part 150 regulations, replacing it with narrower disaggregation alternatives, as described below.

In place of the existing disaggregation relief provided by the Part 150 regulations, which is largely self-executing, the proposed Part 151 regulations would set out three bases for disaggregation, which would be conditioned upon application to, and approval by, the CFTC. First, disaggregation would be available to passive pool investors having an interest of between 10% and 25% in a pool (and who are therefore presumptively required to aggregate the pool's positions for position limit purposes), provided that the investor does not supervise or control the pool's trading and the pool operator has written procedures in place to prevent the investor from gaining knowledge of the pool's trading or positions and has applied for and received disaggregation relief from the CFTC. Disaggregation would also be available upon application by futures

[5] The definition set out in CFTC Regulation 1.3(z) would still apply with respect to "excluded commodities."

commission merchants (FCMs) with respect to discretionary accounts participating in an FCM customer trading program where the FCM does not control trading and maintains minimum control over the accounts, and the trading decisions for the accounts are made independently of trading decisions for the FCM's other accounts.

Finally, the proposed Part 151 Regulations would create a new "owned non-financial entity" exemption, which would allow an entity to disaggregate the positions of a non-financial entity (generally, a non-financial operating company) in which it owns a 10% or greater interest if the applying entity can demonstrate that the owned non-financial entity is independently controlled and managed. The proposed regulations include a non-exclusive list of indicia of independence for purposes of this exemption, including that the two entities have no knowledge of each other's trading decisions, that the owned non-financial entity have written policies and procedures in place to preclude such knowledge, and that the entities have separate employees and risk management systems. However, these criteria are not exhaustive, and an applicant for this exemption would be permitted to describe any relevant circumstances that it believes would warrant disaggregation.

Position Visibility

The CFTC proposal also includes new position visibility requirements for non-agricultural referenced contracts, establishing reporting requirements (including information about both cash market and derivatives activities) for traders who exceed the specified visibility levels. The CFTC expects that the proposed visibility levels for referenced base and precious metals and energy contracts generally will affect approximately 20 to 30 traders annually.

Grandfathering of Existing Positions

The CFTC proposes to allow traders to hold positions in DCM futures and options contracts in excess of the new position limits, provided that such positions were established in good faith prior to the effective date of the new limits. However, the trader would not be permitted to increase its size in any such position after the new limits take effect. With respect to swaps, the CFTC proposal would not apply position limits to Dodd-Frank pre-effective date swaps, and would also allow swap dealers who have previously been granted hedge exemptions to continue to manage the risk of a swap portfolio that exists upon implementation of the new regulations consistent with the exemption, provided that no new swaps thereafter would be covered by the exemption.

The CFTC has requested comment on all aspects of its proposed rules, which can be found here. The comment period closes on March 28.

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