Katten

Have We Finally Reached Our Limits? CFTC Proposes New Position Limits Rules in Effort to End Decade-Long Saga

Friday, February 14, 2020

James Brady, Associate

Gary DeWaal, Special Counsel

Kevin Foley, Partner

Carl Kennedy, Partner

Brief History Lesson

- First set of position limits rules post-Dodd Frank finalized in 2011
- 2011 rules then vacated by D.C. Circuit in 2012
- Subsequent rulemaking proposals issued in 2013 and 2016 (2 proposals, including a supplemental), but never finalized
- Two proposals also issued focused on aggregation of positions (2013 and 2016)

What Are the Limits?

- Spot month limits on 25 referenced contracts
  - 16 agricultural (9 legacy, plus 7 new), 4 energy and 5 metals
  - Set at ≤ 25% total deliverable supply (based on DCM supplied data)
  - Separately calculated by settlement (*i.e.*, cash-settled and physical-settled cannot be netted against each other)
- Non-spot month limits on only the 9 legacy agricultural contracts
  - Set at 10% of open interest for first 50,000 contracts (increased from 25,000), then 2.5% open interest thereafter
  - Can be netted across settlement type (unlike spot month limits)

Economically Equivalent Swaps

- Proposed rules would apply to any contract directly or indirectly linked to, or that has pricing relationship with, referenced contracts
- Limits would cover "economically equivalent swaps," which are swaps with identical material contractual specifications, terms and conditions as referenced contracts
  - — Select examples of material provisions: underlying commodity, maturity or termination date, settlement type, delivery specifications
  - — Select examples of disregarded provisions: lot size/notional amount, delivery dates diverging by less than one day (two days for nat. gas)
- Impact of proposed general anti-evasion provision

Bona Fide Hedging

- Revised definition of bona fide hedging
  - — Removes “risk management” hedge
  - — Limited to pricing risk
  - — Eliminates incidental trading test, orderly trading requirement and “five-day” rule
  - — Includes pass-through swaps
- Expanded list of enumerated bona fide hedges
  - — Maintains and somewhat modifies the 6 existing enumerated hedges
  - — Adds 5 new enumerated hedges
- Risk can be measured on gross or net basis; must be consistently measured and reflected in written policies and procedures
- Market participants would have option to request exemptive recognition for non-enumerated bona fide hedges directly from DCMs through more streamlined process

Changes to DCMs' Role

- Proposed rules address DCMs' ability to set exchange-level position limits
  - Spot month limits cannot exceed federal limits
  - Must establish non-spot month limits or accountability levels for all non-legacy contracts (though there are no federal limits for those)
  - Can establish spot and/or non-spot limits on any contract not covered by federal rules

Changes to Reporting

- Elimination of Form 204 (in its entirety) and parts 1 and 2 of Form 304
- Proposal contemplates that CFTC would instead receive monthly data on hedging recognitions and exemptions *via* reporting by DCMs

Discussion of Necessity Finding

- CFTC has preliminarily interpreted relevant sections of the Commodity Exchange Act as requiring that the agency establish those position limits it finds “are necessary to diminish, eliminate, or prevent” certain burdens on interstate commerce
- Proposed rulemaking includes analysis to support such a finding
- Multiple commissioners expressed discomfort with this portion of the proposal