Investment Management Alert

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CFTC Re-Proposes Position Limits for Certain Commodity Futures Contracts and Economically Equivalent Swaps

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Key Points

- Federal spot month limits would expand to cover 25 physical commodity futures, as well as certain “look alike” contracts and OTC swaps on the same underlying commodity.
- Limits generally would be set at higher levels than current federal or exchange-set limits.
- Exchanges would administer the bona fide hedge exemption process.

On January 30, 2020, the Commodity Futures Trading Commission (CFTC) approved a proposed rulemaking (the “Proposal”) to modernize and expand its existing position limits regime for certain U.S. exchange-listed physical commodity futures contracts.[1] In 2011, the CFTC finalized rules to implement provisions of the Dodd-Frank Act regarding position limits and the bona fide hedging definition. However, a federal court vacated the rulemaking the following year, finding that the agency had failed to make a necessity finding as required by statute. While the Commission has since re-proposed various versions of the vacated rules on three separate occasions, none of these have been finalized (with the exception of rules regarding the aggregation of positions for purposes of determining compliance with position limits).[2] The Proposal, if finalized, would mark the completion of one of the only remaining major rulemakings for the CFTC under the Dodd-Frank Act. The CFTC has encouraged market participants to submit public comments, which must be received on or before April 29, 2020.

Contracts Covered by the New Position Limits

Under current rules, federal speculative position limits apply to nine “legacy” agricultural futures contracts (the “Legacy Contracts”), and exchanges are required to establish position limits or accountability levels for all other contracts that they list. The Proposal’s expanded federal speculative limits would apply to the “Referenced Contracts” consisting of: (i) 25 core referenced futures contracts (CRFCs), which include the Legacy Contracts plus 16 additional physical commodity[3] futures contracts (the “New Contracts”) and options thereon; (ii) futures and options that are directly or

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indirectly linked to the price of a CRFC (e.g., a cash-settled "look alike" contract) or to the same commodity underlying the applicable CRFC for delivery at the same location as specified in the CRFC; and (iii) economically equivalent swaps, which are those with "identical material" contractual specifications, terms and conditions as another Referenced Contract (and may include swaps executed bilaterally).[4] Similar to the current position limits regime, positions in Referenced Contracts should be netted such that the speculative limits are applied on a net long or net short basis.[5]

Spot Month Position Limits

Under the Proposal, federal spot month limits would generally be set at or below 25 percent of deliverable supply estimates of the commodity underlying the relevant CRFC, which is calculated using data recently provided by exchanges. Generally, these new proposed limits represent an increase (which in some cases is significant) over current federal or exchange-set limits, as applicable. These limits would apply on a futures-equivalent basis based on the trading unit size of the relevant CRFC. Importantly, federal spot month limits would apply separately to physically delivered and cash-settled Referenced Contracts on the same underlying commodity.[6] Accordingly, a trader would not be able to net across physical-delivery Referenced Contracts and cash-settled Referenced Contracts in the same underlying commodity during the spot month (and would not aggregate positions together from each for purposes of determining compliance with a single limit).

Core Referenced Futures Contract	**2020 Proposed Spot Month Limit**	**Existing Federal Spot Month Limit**	**Existing Exchange-Set Spot Month Limit**
Legacy Agricultural Contracts			
CBOT Corn (C)	1,200	600	600
CBOT Oats (O)	600	600	600
CBOT Soybeans (S)	1,200	600	600
CBOT Soybean Meal (SM)	1,500	720	720
CBOT Soybean Oil (SO)	1,100	540	540
CBOT Wheat (W)	1,200	600	600/500/400/300/220[7]
CBOT KC HRW Wheat (KW)	1,200	600	600
MGEX HRS Wheat (MWE)	1,200	600	600
ICE Cotton No. 2 (CT)	1,800	300	300
Other Agricultural Contracts			
CME Live Cattle (LC)	600/300/200[8]	n/a	450/300/200[9]
CBOT Rough Rice (RR)	800	n/a	600/200/250[10]
ICE Cocoa (CC)	4,900	n/a	1,000
ICE Coffee C (KC)	1,700	n/a	500
ICE FCOJ-A (OJ)	2,200	n/a	300
ICE U.S. Sugar No. 11 (SB)	25,800	n/a	5,000

ICE U.S. Sugar No. 16 (SF)	6,400	n/a	n/a
Metals Contracts			
COMEX Gold (GC)	6,000	n/a	3,000
COMEX Silver (SI)	3,000	n/a	1,500
COMEX Copper (HG)	1,000	n/a	1,500
NYMEX Platinum (PL)	500	n/a	500
NYMEX Palladium (PA)	50	n/a	50
Energy Contracts			
NYMEX Light Sweet Crude Oil (CL)	6,000/5,000/ 4,000[11]	n/a	3,000
NYMEX NYH ULSD Heating Oil (HO)	2,000	n/a	1,000
NYMEX NYH RBOB Gasoline (RB)	2,000	n/a	1,000
NYMEX Henry Hub Natural Gas (NG)	2,000	n/a	1,000

Non-Spot Month Position Limits

The Proposal would establish federal speculative limits outside of the spot month (i.e., single month and all-months-combined limits) for only the Legacy Contracts (including Referenced Contracts thereon). These limits are also generally higher than current levels, set at 10 percent of open interest for the first 50,000 contracts (as opposed to the first 25,000 contracts currently), with an incremental increase of 2.5 percent of the open interest thereafter. In a major break from previous proposals, the New Contracts (including exchange-listed Referenced Contracts thereon) would not be subject to federal limits outside of the spot month and, instead, would be subject to either an exchange-established position limit or position accountability level.

Core Referenced Futures Contract	**2020 Proposed Single Month and All-Months Combined Limit Based on New 10/2.5 Formula for First 50,000 OI**	**Existing Federal Single Month and All-Months-Combined Limit**	**Existing Exchange-Set Single Month and All-Months-Combined Limi**
CBOT Corn (C)	57,800	33,000	33,000
CBOT Oats (O)	2,000	2,000	2,000
CBOT Soybeans (S)	27,300	15,000	15,000
CBOT Soybean Meal (SM)	16,900	6,500	6,500
CBOT Soybean Oil (SO)	17,400	8,000	8,000
CBOT Wheat (W)	19,300	12,000	12,000
KC HRW Wheat (KW)	12,000	12,000	12,000
MGEX HRS Wheat (MWE)	12,000	12,000	12,000

ICE Cotton No. 2 (CT)	11,900	5,000	5,000

Exchange-Set Position Limits

An exchange listing a Referenced Contract would be required to set position limits for such contract no higher than the federal limit discussed above. For any futures, or option on a futures, contract in a physical commodity that is not a Referenced Contract (whether cash- or physically-settled), the Proposal would require the exchange listing such contract to establish a spot-month limit that is no greater than 25 percent of deliverable supply for the underlying physical commodity, with flexibility for the exchange to submit other formulas for the CFTC to consider. Outside of the spot month (including with respect to New Contracts), the exchange would have discretion to establish position limits or position accountability levels[12] for these physical commodity futures and options on futures contracts based on example formulas and acceptable practices provided by the CFTC. One of the position limits regulations contemplates swaps and swap execution facilities, although the Proposal specifically notes that any requirements relating to exchange-set limits on swaps would be phased in at a later time. Accordingly, only swaps that are economically equivalent to a Referenced Contract would be subject to federal limits, such swap would not be subject to position limits under the Proposal.[13]

Bona Fide Hedge Exemption

Under the Proposal, a bona fide hedging transaction or position may continue to exceed federal position limits. A bona fide hedging transaction is defined as a position: (1) represents a substitute for transactions made at a later time in a physical marketing channel; (2) is economically suitable to the reduction of risks in the conduct and management of a commercial enterprise; and (3) arises from the potential change in value of actual or anticipated assets, liabilities or services. However, the Proposal would clarify that the “temporary substitute” test must be met at all times, rather than normally, such that market participants would no longer be able to treat “risk management” positions as bona fide hedges that can exceed position limits for physical commodity derivative contracts.[14] In addition, under the Proposal, market participants would no longer be prohibited from maintaining bona fide hedge positions during the last five trading days of the spot period for a Referenced Contract, unless the relevant listing exchange determines to impose such a restriction in its discretion based on knowledge of the underlying market.

The Proposal would expand the current list of enumerated bona fide hedges to include, among others,[15] hedges of anticipated merchandising which the CFTC had previously declined to endorse in its most recent proposals. To the extent market participants enter into an enumerated bona fide hedge position in a Referenced Contract in accordance with the general criteria set forth in the paragraph above, such exemption would be self-effectuating under the Proposal such that market participants would only need to request the exemption from the relevant listing exchange if required under such exchange’s rules.

The Proposal would still allow market participants to rely on non-enumerated bona fide hedges, but would change the process by which such an exemption request is approved. Whereas market participants currently may be required to apply to both the CFTC and the listing exchange with respect to a Legacy Contract, under the Proposal, a market participant would only be required to apply with the relevant listing exchange (regardless of whether the contract is a Legacy Contract) in order to have its non-enumerated hedge recognized as bona fide for purposes of both federal and exchange-set limits, as applicable. If granted, the exchange would notify both the CFTC and the applicant simultaneously, and the applicant could begin to rely on the exemption ten business days after receiving such notification, unless the CFTC (through its commissioners only and not staff) notifies it during such time period that it has overruled the exchange's approval. A two business day approval process would also be available under the Proposal for persons demonstrating a more immediate need. The Proposal would require market participants to renew their applications at least annually, but largely leaves other timing requirements to the discretion of the exchanges.

Form 204

The 2020 Proposal would eliminate Form 204 altogether, which market participants with bona fide hedge positions in excess of federal limits currently are required to file each month with the CFTC to demonstrate cash market positions justifying such overages. Consistent with the streamlined bona find hedge exemption application process discussed above, Form 204 would no longer be necessary for the CFTC to collect and review as exchanges will be evaluating applications for bona fide hedge exemptions, which will be required to solicit information on cash market positions that is updated on at least an annual basis in support of the bona fide hedge exemption request. However, to ensure sufficient data is available for the CFTC to perform oversight of the exchange-administered exemption process, the Proposal would allow for the CFTC to continue to issue special calls to market participants for cash market position information, and impose specific reporting and recordkeeping requirements on exchanges. First, exchanges would be required to collect and maintain all exemption application materials in accordance with the CFTC's general recordkeeping regulations, updated on an annual basis, with information regarding the applicant's activity in the cash markets and regarding the application's suitability for an exemption. Finally, consistent with existing industry practice for many exchanges, the exchange would be required to file monthly reports with the CFTC showing, among other things, a summary of the bona fide hedge exemption applicant's activity in the cash markets.

[1] The Proposal is available online at: https://www.cftc.gov/media/3366/federalregister013020b/download.

[2] See 17 CFR 150.4. Please refer to our existing client alert for additional information, available online at: https://www.akingump.com/en/news-insights/cftc-adopts-amendments-to-position-limit-aggregation-exemption.html.

[3] The Proposal defines "physical commodity" as any "agricultural commodity" as defined in 17 CFR 3.1 or any "exempt commodity" as defined in Commodity Exchange Act section 1a. Accordingly, the Proposal does not affect derivative contracts on financial commodities such as interest rates, currencies or credit risk, which listing exchanges would still have discretion over to establish limits or accountability levels.

[4] Swaps that differ from a Referenced Contract based on lot size or notional amount, the delivery date diverging by less than one calendar day (non-natural gas) or two calendar days (natural gas), or post-trade risk management arrangements will still be deemed to be economically equivalent.

[5] Any swap position that is not deemed economically equivalent to any other Referenced Contract could not be netted against such other Referenced Contracts nor would it be required to be aggregated with any Referenced Contract for federal position limits purposes.

[6] The Proposal would also implement a "conditional limit" for natural gas Referenced Contracts. During the spot month, market participants could hold up to 10,000 futures contracts that cash-settle based on the price of the NYMEX Henry Hub (NG) physically-settled natural gas contract (as opposed to the otherwise applicable 2,000 contract limit), as well as an additional 10,000 contracts in cash-settled natural gas economically equivalent swaps, provided that such participants exit their spot month position in NG.

[7] The existing exchange-set limit for Wheat (W) is 600 contracts. However, for the May contract month, the limit changes dependent deliverable supply that it publishes from the CBOT's Stocks and Grain report on the Friday preceding the first notice day for the May contract month. In the last five trading days of the expiring futures month in May, the speculative position limit is: (1) 600 contracts if deliverable supplies are at or above 2,400 contracts; (2) 500 contracts if deliverable supplies are between 2,000 and 2,399 contracts; (3) 400 contracts if deliverable supplies are between 1,600 and 1,999 contracts; (4) 300 contracts if deliverable supplies are between 1,200 and 1,599 contracts; and (5) 220 contracts if deliverable supplies are below 1,200 contracts.

[8] Similar to the existing step-down limit, the Proposal contemplates a similar step-down exchange-set limit. The proposed federal spot month step-down limit is: (1) 600 at the close of trading on the first business day following the first Friday of the contract month; (2) 300 at the close of trading on the business day prior to the last five trading days of the contract month; and (3) 200 at the close of trading on the business day prior to the last two trading days of the contract month.

[9] The existing exchange-set limit for Live Cattle (LC) has a step-down spot month limit of: (1) 450 at the close of trading on the first business day following the first Friday of the contract month; (2) 300 at the close of trading on the business day prior to the last five trading days of the contract month; and (3) 200 at the close of trading on the business day prior to the last two trading days of the contract month.

[10] The existing exchange-set spot month limit for all contracts months of Rough Rice (RR) is 600 contracts. However, for July and September, there is a step-down limit from 600 contracts. In the last five trading days of the expiring futures month, the speculative position limit for the July futures month steps down to 200 contracts from 600 contracts, and the speculative position limit for the September futures month steps down to 250 contracts from 600 contracts.

[11] The Proposal seeks to implement a step-down federal spot position limit for its Light Sweet Crude Oil (CL) futures contract: (1) 6,000 contracts as of the close of trading three business days prior to the last trading day of the contract; (2) 5,000 contracts as of the close of trading two business days prior to the last trading day of the contract; and (3) 4,000 contracts as of the close of trading one business day prior to the last trading day of the contract.

[12] The Proposal would define "position accountability" consistently with the concept as it exists under exchange rules currently: a level above which a trader would be required to (1) provide the listing exchange with requested information about its position and (2) halt increasing further or reduce in an orderly manner its position upon request by the listing exchange.

[13] The CFTC expects that most economically equivalent swaps that are subject to federal limits under the Proposal would be traded over-the-counter (OTC) (as opposed to on a swap execution facility).

[14] Risk management positions could still be recognized by exchanges with respect to futures and options on futures in financial commodities such as interest rates, currencies or credit risk. In addition, the Proposal would allow a market participant entering into a Referenced Contract that is an economically equivalent swap and for whom such swap would not qualify as a bona fide hedge (Pass-Through Swap Participant), to nonetheless treat such swap (Pass-Through Swap) as a bona fide hedge if its counterparty is entering into the swap as a bona fide hedge; provided that the Pass-Through Swap Counterparty then offsets some or all of the price risk from the Pass-Through Swap by entering into a futures, option on a futures or swap position in the same underlying physical commodity (and such offsetting position would be treated as a bona fide hedge as well).

[15] The proposed enumerated bona fide hedges include: (1) hedges of ownership or fixed-price cash commodity purchases and hedges of unsold anticipated production; (2) hedges of fixed-price cash commodity sales and hedges of unfilled anticipated requirements; (3) hedges of offsetting unfixed-price cash commodity sales and purchases; and (4) cross-commodity hedges. This Proposal will expand the list to cover (5) hedges by agents, (6) hedges of anticipated royalties, (7) hedges of services, (8) offsets of commodity trade options and (9) hedges of anticipating merchandising.

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