

Investment Funds Alert

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

February 4, 2011

On January 13, 2011, the Commodity Futures Trading Commission (CFTC) proposed new Part 151 of its regulations pursuant to its authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires the CFTC to establish combined position limits for futures contracts and contracts that are related thereto. The CFTC's newly proposed regulations would establish speculative position limits relating to certain U.S. exchange-listed physical commodity futures contracts, as well as to swaps that reference such contracts and certain contracts executed on, or pursuant to, rules of a foreign board of trade (FBOT)¹. The CFTC is proposing to establish the new position limits in two phases. In the first phase, the CFTC would subject specified futures contracts and certain contracts that settle or are priced against those futures contracts to spot-month position limits based upon current designated contract market spot-month limits. In the second phase, non-spot-month limits would be adopted based on open-interest levels to be ascertained by the CFTC's staff during the first quarter of 2012 following implementation of the CFTC's position reporting rules (unless the CFTC determines that there are certain commodities for which data is sufficient to implement the position limits sooner). In addition, during the second phase, the CFTC would also establish spot-month limits based on information that has been obtained by the CFTC staff. No aggregate and single-month position limits would actually be implemented until the CFTC has had the ability to monitor actual trade data.

Contracts Are Covered by the Proposed Position Limits

The proposed position limits would provide position limits for 28 "core" futures contracts and their economic equivalents, which would include contracts for 19 agriculture commodities (including the nine legacy futures contracts currently subject to CFTC position limits in CFTC Regulation 150.2), five metal commodities and four energy commodities.² Swaps and options on the future contracts or on a related swap (referred to in the proposed regulations as, together with the underlying commodity future, a "Referenced Contract") would be captured in the limit if either (i) the price of the swap refers to a covered futures contract settlement price or (ii) the swap is priced on the same commodity delivered at the same location or another delivery location that has similar supply and demand characteristics as those specified in a covered contract.

¹ If the FBOT provides direct access, and its contracts settle against the above contracts.

² The "core" agricultural commodity contracts would be (1) ICE Futures Cocoa, (2) ICE Futures U.S. Coffee, (3) Chicago Board of Trade Corn, (4) ICE Futures U.S. Cotton No. 2, (5) Chicago Mercantile Exchange Feeder Cattle, (6) ICE Futures U.S. FCOJ-A, (7) Chicago Mercantile Exchange Lean Hog, (8) Chicago Mercantile Exchange Live Cattle, (9) Chicago Mercantile Exchange Class III Milk, (10) Chicago Board of Trade Oats, (11) Chicago Board of Trade Rough Rice, (12) Chicago Board of Trade Soybeans, (13) Chicago Board of Trade Soybean Meal, (14) Chicago Board of Trade Soybean Oil, (15) ICE Futures U.S. Sugar No. 11, (16) ICE Futures U.S. Sugar No. 16, (17) Chicago Board of Trade Wheat, (18) Minneapolis Grain Exchange Hard Red Spring Wheat and (19) Kansas City Board of Trade Hard Winter Wheat. The core metal futures contracts would be (1) Commodity Exchange, Inc. Gold, (2) Commodity Exchange, Inc. Silver, (3) Commodity Exchange, Inc. Copper; (4) New York Mercantile Exchange Palladium and (5) New York Mercantile Exchange Platinum. The core energy commodity futures contracts would be (1) New York Mercantile Exchange Light Sweet Crude Oil, (2) New York Mercantile Exchange New York Harbor No. 2 Heating Oil, (3) New York Mercantile Exchange New York Harbor Gasoline Blendstock and (4) New York Mercantile Exchange Henry Hub Natural Gas.



Spot-Month Position Limits

The proposed regulations would, subject to the exceptions discussed below, prohibit any trader from holding or controlling positions on a net long or net short basis in excess of the specified limit. Spot-month³ limits for physical delivery Referenced Contracts would be set at 25 percent of estimated deliverable supply. An additional position limit would apply for cash-settled contracts, including cash-settled futures and swaps. The proposed regulations would provide an increased spot-month limit for cash-settled Referenced Contracts equal to five times the spot-month position limit for physical delivery Referenced Contracts so long as the trader (i) does not hold or control positions in the cash-settled contract exceeding the level of any single-month position limit, (ii) does not hold or control positions in the physical delivery commodity futures contract or other Referenced Contract that is in its spot month, (iii) does not hold or control cash or forward positions in the Referenced Contract's spot month in an amount that is greater than 25 percent of the deliverable supply in the Referenced Contract's underlying commodity deliverable at the same location as the position referenced in the underlying commodity futures contract and (iv) has submitted a certification to the CFTC that the trader meets these obligations.

Deliverable supply will be determined by the CFTC on an annual basis, following receipt by the CFTC of an estimate of deliverable supply by the applicable designated contract market by December 31 of each year, together with a description of the methodology used to derive the estimate and supporting statistical data.

Non-Spot-Month Position Limits

Under the proposed regulations, the position limits for class and aggregate single-month and all-months-combined position limits would be established during the second phase of implementation. For these purposes, futures and options thereon are considered one class, and swaps are considered another class. Unlike spot-month position limits, which are based upon a percentage of deliverable supply, the non-spot-month position limits would be based upon overall open interest for a particular Referenced Contract in the aggregate or on a per class basis. The proposed position limits for the all-months-combined aggregate position would be set at 10 percent of the open interest for all months listed on a reporting market during the most recent calendar year, up to 25,000 contracts with a marginal increase of 2.5 percent of the open interest thereafter. All-months-combined and single-month position limits will be fixed by the CFTC for Referenced Contracts of the same class, at a level equal to the all-months-combined aggregate position limit.

The proposed regulations would retain the all-months-combined position limits for the nine enumerated agricultural commodities for which there are currently position limits under Part 150.2 of the CFTC regulations.

Exemptions

Bona Fide Hedging

The proposed regulations would include an exemption for bona fide hedging activities, but they would use a separate definition of what constitutes "bona fide hedging activities" as opposed to the traditional "bona fide hedging" definition in Regulation 1.3(z). A position will be considered a bona fide hedging position for the purposes of the spot-month and the non-spot-month position limits, to the extent that the position (i) 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, (ii) is economically appropriate for the reduction of risks in the conduct and management of a "commercial enterprise" and (iii) arises from the potential change in value of the person's current or anticipated (a) assets that the person owns, produces, manufactures or merchandises, (b) liabilities that a person has or (c) services that the person provides or purchases. The bona fide hedging exemption would also apply to positions resulting from a swap that was executed opposite a counterparty for which the swap would qualify for a bona fide hedging exemption as defined above. With respect to anticipatory hedge exemptions, traders who are relying on the bona fide hedge exemption based on anticipated needs will need to submit a filing with the CFTC at least 10 days in advance of the date that such transactions or positions would be in excess of the proposed position limits.

³ The "spot month" would be defined in Regulation 151.3 for each group of core futures contracts. The new proposed regulations would define the spot month for Referenced Contracts versus the core futures contract overlying the same commodity.

Preexisting Positions

The proposed rules would provide a limited exemption for positions in contracts on designated contract markets that are in excess of specified position limits, provided that they were established in good faith prior to the effective date of the new position limits.

Aggregation of Positions

The proposed regulations would require aggregation for speculative position limits at the owner level and would not provide an “independent account controller” exemption. The position limits would apply on an aggregate basis (i) to all positions in all accounts for which any trader indirectly holds positions or controls trading, (ii) to positions held by two or more traders acting pursuant to an express agreement and (iii) to all accounts in which a trader holds more than a 10 percent interest. Traders who control or hold positions pursuant to identical trading strategies will be required to aggregate such positions.

In addition, persons trading in commodities or owning portions of commodity pools would need to aggregate positions at both the owner and account controller level. Unless the relevant trader is able to establish that it is separate from the commodity pool operator, persons who have a 10 percent or more equity interest in an account in, or control over, a commodity pool would be required to aggregate the speculative position of each pool in which they have such an interest for purposes of computing position size and determining compliance with the position limits, irrespective of whether the person controlling the account was independent. A trader may be deemed to be separate if (i) the pool operator has and enforces written procedures to preclude the trader from having knowledge of, gaining access to, or receiving data about, the trading or positions of the pool, (ii) the trader does not have direct, day-to-day supervisory authority or control over the pool’s trading decision and (iii) the pool operator has received an exemption from aggregation from the CFTC. Commodity pool operators and persons with an interest of 25 percent in a pooled commodity pool must aggregate the positions in such commodity pool with all other accounts or positions owned or controlled by that person, without exception.

Certain futures commission merchants may be exempt from aggregating positions in certain discretionary accounts if (i) the futures commission merchant maintains only minimal control over trading in the account and does not direct trading in the account, (ii) the trading decisions made for the account are independent from the trading decisions made in the futures commission merchant’s other accounts and (iii) the futures commission merchant has received an exemption from aggregation from the CFTC.

Certain entities would not be required to aggregate positions with the positions of an owned non-financial entity if (i) the entity and its affiliates have no knowledge of trading decisions by the owned non-financial entity, and the owned non-financial entity has no knowledge of trading decisions made by the entity or any of the entity’s other affiliates, (ii) the owned non-financial entity’s decisions are controlled by the owned non-financial entity’s employees, who do not share any trading control with the entity, (iii) the owned non-financial entity has written policies and procedures to preclude the entity from having knowledge of, or gaining access to, or receiving information about, its positions, trades or trading strategies and (iv) the owned non-financial entity has a separate risk management system from the entity. An owned non-financial entity is an entity in which the owner has at least a 10 percent interest and is not a “financial entity.” The definition of “financial entity” would include many eligible contract participants, such as registered investment advisers or commodity trading advisers regulated by the CFTC.

In each of these three exemptions from aggregation, the party seeking the exemption would be required to affirmatively obtain the CFTC’s approval of an application to utilize the exemption.

No “Crowding Out” Provision

Notably, the proposal eliminates the “crowding out” provisions from its January 2010 proposed rule, which would have prevented an entity that holds hedging positions in excess of the applicable position limit from holding any speculative positions.

Visibility Reporting Requirements

The proposed rules would also require traders whose positions in all months or in any single month exceed specified trading levels in certain metals and energy Referenced Contracts⁴ to report their positions to the CFTC, broken down by futures contracts, options on futures contracts, swaps and options on swaps. These regulations aim to make the activity of the largest traders in Referenced Contracts visible to the CFTC. The CFTC may revisit the levels at which traders are required to report positions as it receives data regarding the swaps markets.

Potential for Adoption

The CFTC commissioners voted in favor of issuing the proposed regulations 4-1, with only Commissioner Jill Sommers voting against the issuance of the proposed regulations. From their opening statements at the public announcement of the new proposed regulations, however, it was evident that some of the commissioners voted in favor of the proposal with some hesitation due to uncertainty regarding market data on swap activity.

Comment Period

The comment period will end on March 14. We will keep you up to date should the proposed regulations be adopted as final rules.

CONTACT INFORMATION

If you have any questions concerning this alert, please contact —

Mark H. Barth
mbarth@akingump.com
212.872.1065
New York

J.P. Bruynes
jpbuynes@akingump.com
212.872.7457
New York

Prakash H. Mehta
pmehta@akingump.com
212.872.7430
New York

Fadi G. Samman
fsamman@akingump.com
202.887.4317
Washington, D.C.

David M. Billings
dbillings@akingump.com
44.20.7012.9620
London

Burke A. McDavid
bmcdavid@akingump.com
214.969.4295
Dallas

Eliot D. Raffkind
eraffkind@akingump.com
214.969.4667
Dallas

Stephen M. Vine
svine@akingump.com
212.872.1030
New York

⁴ The Referenced Metals Contracts for which reports must be filed would include (1) New York Mercantile Exchange Copper, (2) New York Mercantile Exchange Palladium, (3) New York Mercantile Exchange Platinum, (4) New York Mercantile Exchange Gold and (5) New York Mercantile Exchange Silver. The Referenced Energy Contracts for which reports would be required would include (1) New York Mercantile Exchange Light Sweet Crude Oil, (2) New York Mercantile Exchange New York Harbor Gasoline Blendstock, (3) New York Mercantile Exchange Henry Hub Natural Gas and (4) New York Mercantile Exchange New York Harbor No. 2 Heating Oil.