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Investment Funds Alert

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

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The Commodity Futures Trading Commission (CFTC) recently adopted final regulations as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") establishing speculative position limits relating to certain U.S. exchange-listed physical commodity futures contracts, as well as to swaps that reference the specified contracts and contracts settling against the specified contracts that are executed on, or pursuant to, rules of a foreign board of trade (FBOT) providing direct access to U.S. persons. The CFTC is planning to establish the new position limits in two phases. In the first phase, position limits will be effective for all spot-month contracts and non-spot-month "legacy" contracts 60 days after the term "swap" is further defined for purposes of the Dodd-Frank Act. In the second phase, non-spot-month limits for non-legacy contracts will be set following the collection of approximately 12 months of swaps positional data.

Contracts Covered by the New Position Limits

The new position limits would provide position limits for 28 "core" futures contracts, which include contracts for 19 agricultural 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.[1] Swaps and options on the future contracts or on a related swap (referred to in the regulations, together with the underlying commodity future, as a "Referenced Contract") are captured in the limit if they are directly or indirectly linked to, partially or fully settled on, or priced at a fixed differential to (i) the price of the named futures contract or (ii) the price of the same commodity delivered at the same location.

[1] The "core" agricultural commodity contracts are (1) ICE Futures U.S. 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 are (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 are (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.

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Spot-Month Position Limits

The regulations, subject to the exceptions discussed below, will prohibit any trader from holding or controlling positions on a net long or net short basis in excess of the specified limit. Spot-month[2] limits for physical delivery Referenced Contracts will be set at 25 percent of estimated deliverable supply. The CFTC adopted an additional position limit for cash-settled Referenced Contracts (other than certain natural gas contracts described below) that will also be set at 25 percent of estimated deliverable supply. Other than for the purposes of computing the aggregate limit for New York Mercantile Exchange Henry Hub Natural Gas Referenced Contracts ("Henry Hub Contracts"), however, cash-settled contracts may not be netted with physical delivery contracts. The spot month limits have been initially determined and set forth on Appendix A (available here) to the Rules but will be adjusted on an annual (for agricultural Referenced Contracts) or biennial (for metal and energy Referenced Contracts) basis as information regarding deliverable supply is later delivered by the designated contract markets (DCMs). A special rule applies, however for Henry Hub Contracts. Under a CFTC interim final rule, cash-settled Henry Hub Contracts will have a class limit of five times the level of the limit for the physical-delivery Henry Hub Contracts. In addition to the spot-month limit for cash-settled natural gas contracts, the interim final rule also provides for an aggregate spot-month limit for the physical-delivery natural gas Henry Hub Contracts together with cash-settled Henry Hub Contracts set at five times the level of the spot-month limit in the relevant physical-delivery natural gas Referenced Contract. A trader, therefore, must at all times fall within the class limit for the physical-delivery Henry Hub Contract, the five-times limit for cash-settled Henry Hub Contracts and the five-times aggregate limit for the Henry Hub Contracts. The proposed rules would have set higher cash-settled spot month positions for all contracts, but the higher limit was not adopted.

Non-Spot-Month Position Limits

Under the regulations, the position limits for class and aggregate single-month and all-months-combined position limits will be established during the second phase of implementation for non-legacy Referenced Contracts (i.e., following the collection of 12 months of positional data), but during the first phase (i.e., 60 days after defining the term "swap") for legacy Referenced Contracts. Unlike spot-month position limits, which are based upon a percentage of deliverable supply, the non-spot-month position limits will be based upon overall open interest for a particular Referenced Contract in the aggregate or on a per class basis. The position limits for the all-months-combined aggregate position will each 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. The all-months-combined and single-month position limits will be fixed by the CFTC for Referenced Contracts at the same level.

With respect to initial non-spot-month position limits for non-legacy Referenced Contracts, the CFTC will calculate and publish a limit after it has received data sufficient to determine average all-months-combined aggregate open interest for a full 12-month period for futures, cleared swaps and uncleared swaps. The aggregate open interest will be derived from various sources. Subsequent non-spot-month limits for non-legacy Referenced Contracts will be updated and published every two years, commencing two years after the initial determinations. These subsequent position limits will be based on the higher of the most recent 12 months average all-months-combined aggregate open interest or 24 months average all-months-combined aggregate open interest. These limits would be made effective on a staggered basis as expressly set forth for the each type of Referenced Contract after the date of publication on the CFTC's Web site. The non-spot month for the legacy Referenced Contracts are set forth in Regulation 151.4 (available here). Unlike spot-month limits, non-spot-month limits will be computed on a net basis across physically cash-settled Referenced Contracts.

[2] The "spot month" is defined in Regulation 151.3 for each group of core futures contracts. The new regulations would define the spot month for referenced contracts versus the core futures contract overlying the same commodity.

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Exemptions

Bona Fide Hedging

The regulations include an exemption for bona fide hedging activities, but the definition of "bona fide hedging activities" differs from the traditional "bona fide hedging" definition in Regulation 1.3(z). Positions will be considered bona fide hedging positions that may exceed the spot-month and the non-spot-month position limits, to the extent that the positions: (i) represent a substitute for transactions made or to be made or positions taken or to be taken at a later time in the physical marketing channel, (ii) are economically appropriate to the reduction of risk in the conduct and management of a commercial enterprise and (iii) arise from assets that a person owns, produces, manufactures, processes or merchandises (or anticipates so doing); liabilities that a person owns or anticipates incurring; or services that a person provides, purchases or anticipates providing or purchasing. The bona fide hedging exemption will also apply to positions resulting from a swap that was executed opposite a counterparty for which the swap qualifies for a bona fide hedging exemption as defined above. Notably, the regulation eliminates the "crowding out" provisions from its January 2011 proposed rule, which would have prevented an entity that holds hedging positions in excess of the applicable position limit from holding any speculative positions.

In addition to the above factors, the particular hedging transaction must fall within one of the specified categories set forth in the CFTC regulations and must satisfy the particular requirements set forth for each type of hedging transaction, which categories include—

- sales of Referenced Contracts equal to the cash commodity position owned, purchased or anticipated to be produced and sold within one year
- purchases of Referenced Contracts equal to the amount of the underlying cash commodity or related by product sold or anticipated to be purchased as part of its business within one year
- calendar spread Referenced Contracts offsetting the cash commodities purchased and sold in different delivery months
- offsetting merchandising hedging transactions for current or anticipated amounts to be merchandised within a year
- sales or purchases of Referenced Contracts to offset anticipated changes in the value of royalty rights in the next year
- sales or purchases of Referenced Contracts to offset the anticipated change in the value of receipts or payments to be due under an executed contract for services
- sales and purchases of Referenced Contracts described above to offset fluctuations in the value of an actual or anticipated cash position.

Persons who enter into swaps as counterparties to persons who would be able to satisfy one of the above-enumerated hedging categories will result in the "pass-through swaps" being an enumerated transaction and would allow the non-hedging counterparty to purchase or sell Referenced Contracts to reduce the risks of those pass-through swaps. Persons who are entering into other risk-reducing practices commonly used in the market may, however, request relief from the CFTC. Persons relying on the bona fide hedge exemptions are required to file a Form 404, 404A or 404S—depending on the type of bona fide hedge exemption claimed—with the CFTC no later than the date of first use of the exemption or least 10 days in advance of the date on which the trader anticipates exceeding the position limits, depending on the type of bona fide hedge exemption claimed.

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Preexisting Positions

The rules will 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 final regulations will require the aggregation of positions owned through various entities under common partial ownership or control if those entities are sufficiently related, but the CFTC significantly expanded its exemptions from required aggregation. A trader will be required to aggregate its position with the entire position held by (i) accounts through which the trader indirectly holds positions or for which the trader controls trading, (ii) accounts controlled by another trader acting pursuant to an express or implied agreement and (iii) accounts in which a trader holds an equity or ownership interest of 10 percent or more (other than passive ownership as a limited partner or shareholder unless affiliated with the commodity pool operator (CPO)). In addition, traders must, notwithstanding any other provision, aggregate positions of accounts that the trader holds or controls, including passively managed index funds, that have identical trading strategies.

The CFTC revised and expanded its exemptions from aggregation in part in response to comments from the futures industry. First, the CFTC will retain the "independent account controller" exemption in existing §150.4 for position limits (other than in the spot month for physically settled contracts) so long as—

- the independent account controller[3] does not itself exceed the position limits
- any independent account controller affiliated with an eligible entity or another independent account controller
  - adopts and enforces written procedures to prevent an affiliated entity from having knowledge of, or gaining access to, data about the trades of the other, which procedures must satisfy specified requirements
  - trades accounts pursuant to separately developed and independent trading systems
  - markets trading programs separately
  - solicits funds through a separate disclosure document
- the independent account controller has filed a notice with the CFTC.

Second, as set forth in the proposal, a limited partner or similar commodity pool participant that is also a principal or affiliate of the CPO is not required to aggregate the positions that it does not control (or have day-to-day supervisory authority or control over the investment decisions of) so long as it has adopted and enforces written procedures to prevent the CPO from receiving information regarding the trading or positions of the pool and has filed a notice with the CFTC. However, each limited partner or similar commodity pool participant that has an ownership or equity interest of 25 percent or more and is exempt from registration under Regulation 4.13 must aggregate the positions of the pool with all other accounts or positions it owns or controls.

A futures commission merchant (FCM) will be required to aggregate the positions that it holds with the discretionary accounts of its separately organized affiliates; accounts that participate in, or receive advice from, its customer trading

[3] An "independent account controller" is a person who (i) is specifically authorized by an eligible entity (such as a CPO, whether registered or exempt, or a commodity trading advisor (CTA)), (ii) is subject to only such minimum control as is consistent with the eligible entity's fiduciary responsibility to fulfill its supervisory duties, (iii) trades independently of the eligible entity, (iv) has no knowledge of trading decisions by any other account controller and (v) is registered as an FCM, introducing broker, a CTA, an associated person of the above or is the general partner of a pool, the CPO of which is exempt under Regulation 4.13.

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program; or its agents, unless (i) the FCM and its affiliates maintain only minimal control over trading in the account and do not direct trading in the account and (ii) the trading decisions made for the account are determined independently from the trading decisions made in the other accounts the FCM holds, or its affiliate controls or in which either has a 10 percent interest.

Visibility Reporting Requirements

The 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 Contracts to report their positions to the CFTC, broken down by futures contracts, options on futures contracts, swaps and options on swaps. The CFTC may revisit the levels at which traders are required to report positions as it receives data regarding the swaps markets. The visibility levels are set forth here.

DCM and SEF Rules

DCMs and swap execution facilities (SEFs) are also required to set position limits for referenced contracts at levels no greater than those established under CFTC regulations. DCMs and SEFs may set accountability levels instead of position limits for contracts that are not Referenced Contracts, contracts relating to a major foreign currency, excluded commodities that are indexes or measures of inflation or another macroeconomic index or measure and certain other specified excluded commodities.

Recent Challenge to Position Limits

The International Swaps and Derivatives Association (ISDA) and the Securities Industry and Financial Markets Association (SIFMA) filed a legal challenge to the CFTC's position limit rules on December 2, 2011. Among other things, ISDA and SIFMA claim that the Dodd-Frank Act does not require the CFTC to adopt position limits unless it determines that position limits are necessary and appropriate. According to the ISDA and SIFMA, the CFTC failed to gather the evidence required to support the necessity and appropriateness of the position limits. The D.C. Circuit, which will adjudicate ISDA's and SIFMA's legal challenge, recently emphasized the importance of empirical support and a complete cost-benefit analysis in *Business Roundtable and Chamber of Commerce of the United States vs. Securities and Exchange Commission* in overturning the SEC's proxy access rule.

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