

CFTC adopts amendments to position limit aggregation rules

J.P. Bruynes, Jason Daniel and Libbie Walker

Abstract

Purpose – To explain the final position limit aggregation rules and exemptions pertaining to derivative positions in nine agricultural commodities adopted by the Commodity Futures Trading Commission on December 5, 2016 and effective February 14, 2017, the notice filing deadline with respect to which was extended by the CFTC by limited time no-action relief until August 14, 2017.

Design/methodology/approach – Explains the position limit aggregation rules and exemptions pertaining to equity interests in owned entities, ownership or equity interests in pooled accounts or positions, positions of an “eligible entity” in connection with client positions carried by an “independent account controller,” positions held by futures commission merchants (FCMs) in discretionary accounts or customer trading program accounts, equity interests of underwriters based on unsold allotments of securities in distributions, broker-dealers if the equity interest is acquired in the normal course of business and positions for which information cannot be collected without risk of violating a law.

Findings – Unless an exemption from aggregation is available, all positions in accounts for which any person controls the trading or holds a 10 per cent or greater ownership or equity interest must be aggregated with positions held, and trading done, by such person. The final rule adds several new exemptions, including for persons with a 10 per cent or greater ownership or equity interest in an entity so long as certain conditions establishing independence are met. The final rule requires notice filing to take advantage of most exemptions from aggregation.

Originality/value – Practical guidance from experienced lawyers specializing in securities, funds, and investment management.

Keywords Derivatives, Aggregation, Exemption, Position limit, US Commodity Futures Trading Commission

Paper type Technical paper

J.P. Bruynes (jpbruynes@akingump.com) is a partner at Akin Gump Strauss Hauer & Feld LLP, New York, New York, USA.
Jason Daniel (jdaniel@akingump.com) is a senior counsel at Akin Gump Strauss Hauer & Feld LLP, Dallas, Texas, USA.
Libbie Walker (lwalker@akingump.com) is an associate at Akin Gump Strauss Hauer & Feld LLP, New York, New York, USA.

On December 5, 2016, the Commodity Futures Trading Commission (CFTC) issued a final rule adopting many of its previously proposed amendments to position limit aggregation rules and exemptions pertaining to certain futures contracts and options on nine agricultural commodities^[1] (the “Final Rule”). The Final Rule took effect upon publication in the Federal Register on December 16, 2016 with an effective date on February 14, 2017, the notice filing deadline with respect to which was extended by the CFTC by limited time no-action relief until August 14, 2017.

The Final Rule provides that, unless an exemption from aggregation is available, all positions in accounts for which any person, directly or indirectly, controls the trading or holds a 10 per cent or greater ownership or equity interest must be aggregated with other positions held, and trading done, by such person. Additionally, positions, ownership or equity held, and trading done, by two or more persons acting in concert, whether express or implied, will be treated as if owned or controlled by a single person. If a person holds or controls the trading of positions in more than one account or pool with substantially identical trading strategies, such person must aggregate all such positions with all other positions held by such person, unless an exemption from aggregation set forth in the Final Rule and discussed below applies.

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With the exception of the broker-dealer and underwriter exemptions discussed below, the Final Rule requires a person or entity seeking an aggregation exemption to file a notice with the CFTC. To allow time for due diligence and filing preparation, the Final Rule provides a 60-day window from the time a person acquires an ownership interest until such person is required to file a notice with the CFTC. The CFTC adds a grace period if a person eligible for an exemption does not file in a timely manner. Such person would not be in violation of the aggregation limit so long as a filing is made within five business days after the person becomes aware, or should have become aware, that the notice had not been timely filed.

Owned-entity exemption

In the Final Rule, the CFTC adopts a new aggregation exemption for persons with a 10 per cent or greater ownership or equity interest in an owned entity (other than an interest in a commodity pool). Such persons will be exempt from aggregating the positions of the owned entity, regardless of the size of the stake held in the owned entity, so long as certain conditions establishing independence are met. The conditions require that such person and the owned entity, to the extent that such person is aware, or should be aware, of the activities of the owned entity:

- do not have knowledge of the trading decisions of the other;
- trade pursuant to separately developed and independent trading systems^[2];
- have, and enforce, written procedures to preclude each from having knowledge of, gaining access to or receiving data about trades of the other^[3];
- do not share employees that control the trading decisions of either; and
- do not have risk management systems that permit the sharing of trades or trading strategy^[4].

Additionally, the person relying on the exemption must make a notice filing with the CFTC.

Exemption for pool participants

The Final Rule provides that a limited partner, limited member, shareholder or other similar type of pool participant holding positions in which the person, directly or indirectly, has a 10 per cent or greater ownership or equity interest in a pooled account or positions is not required to aggregate positions with all other positions owned or controlled by such person, unless such person:

1. is the commodity pool operator (CPO) of such pool;
2. has, directly or indirectly, a 25 per cent or greater ownership or equity interest in a pool, if the CPO of the pool is exempt from registration as a CPO pursuant to CFTC Regulation 4.13; or
3. is a principal or affiliate of the CPO of such pool, unless:
 - the CPO has, and enforces, written procedures to preclude such person from having knowledge of, access to, or receiving data about, the positions of the pool;
 - the person does not have direct, day-to-day supervisory authority or control over the pool's trading decisions;
 - if a principal of the CPO, the person maintains only such minimum control over the CPO as is consistent with its responsibilities as a principal and necessary to fulfill its duty to supervise the trading activities of the pool; and
 - the CPO makes a notice filing with the CFTC.

The notice filing requirement for a CPO, if the pool participant is a principal or affiliate of the CPO of such pool, is new to the otherwise existing pool participant exemption. Thus, such persons currently relying on this exemption will need to make a notice filing before the Final Rule takes effect.

Exemption for independent account controllers

Under the Final Rule, an “eligible entity”^[5] is not required to aggregate the eligible entity’s positions with its client positions or accounts carried by an authorized “independent account controller”^[6] (IAC) except for spot-month physical-delivery commodity contracts so long as the IAC does not exceed the position limit. If the IAC is affiliated with such eligible entity or another IAC, additional requirements apply to qualify for an exemption, and each such affiliated entity must:

- have and enforce written procedures^[7] to preclude the affiliated entities from having knowledge of, gaining access to, or receiving data about, trades of the other;
- trade such accounts pursuant to separately developed and independent trading systems;
- market such trading systems separately; and
- solicit funds for such trading by separate disclosure documents that meet the standards of CFTC Regulations 4.24 or 4.34, if required.

The IAC exemption now requires the filing of a notice with the CFTC. Therefore, any entity currently relying on this exemption will need to make a notice filing before the Final Rule takes effect.

Exemption for certain accounts held by futures commission merchants (FCMs)

The Final Rule provides that an FCM or its affiliate is not required to aggregate positions held in discretionary accounts or customer trading program accounts so long as, for each of those accounts:

- a person other than the FCM or affiliate directs trading in the account;
- the FCM or affiliate has only such minimum control over the trading in the account as needed to fulfill its duty to supervise trading in the account;
- each trading decision in the account is determined independently of all trading decisions in other accounts in which the FCM or affiliate controls or holds at least a 10 per cent interest; and
- the FCM makes a notice filing with the CFTC.

The notice filing requirement in the Final Rule is new to the otherwise existing FCM exemption. Therefore, any FCM currently relying on this exemption will need to make a notice filing before the Final Rule takes effect.

Exemptions for underwriters and broker-dealers

The Final Rule provides a new aggregation exemption for underwriting if the ownership or equity interest is based on an unsold allotment of securities in a distribution by, or through, an underwriter. Similarly, the Final Rule also provides broker-dealers registered with the Securities and Exchange Commission or a foreign regulatory authority with an exemption from aggregation of owned entities if the ownership or equity interest is acquired in the normal course of business as a dealer with no actual knowledge of the trading decisions of the known entities. Unlike the other exemptions, there is no notice filing requirement for either the underwriter or broker-dealer exemption.

Exemption where information sharing violates law

The Final Rule provides a new aggregation exemption if the sharing of information necessary to determine aggregate positions creates a reasonable risk of violating federal, state, or foreign law or regulation. The owned entity must make a notice filing with the CFTC and include a written memorandum of law that explains the legal basis for determining that such information sharing creates a reasonable risk that the entity could violate federal, state or foreign law.

Conclusion

The Final Rule adds new exemptions to the CFTC's aggregation rules and amends existing exemptions to include certain notice filing requirements. Market participants should take note of the newly adopted Final Rules on aggregation and begin to make necessary preparations if affected, particularly those currently relying on the relevant pool participant, IAC or FCM aggregation exemptions who are now required to make a notice filing.

Notes

1. See 17 CFR 150. The CFTC re-proposed, but did not adopt, revised combined position limits that also include swaps. This article does not address that re-proposal. If the CFTC's proposed federal speculative position limit regime for certain other futures and related swaps is adopted, the regulations will also apply to the position limits for such futures contracts and swaps.
2. For purposes of the Final Rule, a "trading system" is a process or method for deciding on the timing and direction of trades, and not an "order execution platform," which is a computerized process that accepts inputs of terms of trades desired to be made and then uses pre-determined methods to specifically place those trades in the markets.
3. Such procedures must include document routing and other security procedures or security arrangements, including separate physical locations, which would maintain the independence of the two persons' activities.
4. The Final Rule clarifies that this provision is focused on the sharing of trades or trading strategy with employees who control the trading decisions of the owned entity, rather than sharing information with employees who use the information solely for risk management or compliance purposes, which would generally be permitted.
5. An "eligible entity" means a commodity pool operator; the operator of a trading vehicle that is excluded, or which itself has qualified for exclusion, from the definition of the term "pool" or "commodity pool operator," respectively, under CFTC Regulation 4.5; the limited partner, limited member or shareholder in a commodity pool, the operator of which is exempt from registration under CFTC Regulation 4.13; a commodity trading advisor; a bank or trust company; a savings association; an insurance company; or the separately organized affiliates of any of the above entities.
6. 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 a futures commission merchant (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 CFTC Regulation 4.13.
7. Such procedures must include document routing and other procedures or security arrangements, including separate physical locations, which would maintain the independence

of their activities; provided, however, that such procedures may provide for the disclosure of information that is reasonably necessary for an entity to maintain the level of control consistent with its fiduciary responsibilities to the managed positions and accounts and necessary to fulfill its duty to diligently supervise the trading done on its behalf.

Corresponding author

J.P. Bruynes can be contacted at: jpbruynes@akingump.com

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