

**CFTC PROPOSES SPECULATIVE POSITION LIMITS
FOR REFERENCED ENERGY CONTRACTS**

The Commodity Futures Trading Commission has proposed Federal speculative position limits on certain natural gas, crude oil, heating oil and gasoline futures and options contracts (the "Proposal").¹ The Proposal would apply speculative position limits to the NYMEX's Henry Hub natural gas, Light Sweet crude oil, New York Harbor No. 2 heating oil and New York Harbor gasoline blendstock contracts, in addition to any other contract that is exclusively or partially based on the referenced contracts' commodities deliverable at locations specified in the proposed regulations (collectively, "Referenced Energy Contracts").² The Proposal would also apply to certain energy contracts designated by the CFTC as significant price discovery contracts, which would currently include the IntercontinentalExchange's Henry Financial LD1 Fixed Price natural gas contract.

The proposed speculative limits would be in addition to, and not a substitute for, a reporting market's existing speculative position limits and accountability requirements.³ The CFTC estimated that, due to the high limits proposed, the new rules, if enacted, would currently affect only about ten large traders. The CFTC further noted that several of those traders may be eligible for exemptions. Several CFTC Commissioners raised concerns regarding the Proposal, including that liquidity could move to over-the-counter ("OTC") markets or foreign exchanges, which could result in less transparency. The Commissioners voted to release the Proposal nonetheless. The Proposal includes a series of specific questions attached to this memorandum as Appendix A. Comments are due by April 26, 2010.

Proposed Position Limits

If enacted as written, the Proposal would establish aggregate and exchange-specific spot month, single-month and all-months-combined position limits for the Referenced Energy Contracts based on formulas similar to those used by the CFTC to determine position limits for certain agricultural commodities. The spot month limits would generally be a function of the estimated deliverable supply for physically-settled contracts. The non-spot single-month and all-months-combined limits would be set at a specific percentage of overall trading activity as represented

¹ The Proposal can be found at <http://cftc.gov/lawandregulation/federalregister/proposedrules/2010/2010-1209.html>.

² Basis contracts (futures and options contracts that are cash-settled based on the difference in price of the same commodity (or substantially the same commodity) at different delivery points) and diversified commodity index futures that are based on such contracts' commodities, however, would not be subject to the proposed speculative position limits.

³ Generally, a reporting market's speculative position limits on Referenced Energy Contracts could be lower than, but could not exceed, the Federal speculative position limits set by the CFTC. Under the Proposal, however, there is a minimum position limit with respect to Referenced Energy Contracts of the same class traded on a single reporting market (described below).

by open interest. In addition, unlike the current Federal limits in certain agricultural commodities, the Referenced Energy Contracts' all-months-combined and spot month limits would automatically be reset each year so that they will remain at specific percentages of each contract's average open interest during the prior year (as described below) and will not require a new rule to be adjusted. Large traders in Referenced Energy Contracts would also be subject to new reporting requirements.

The spot month limit for physically-delivered contracts would be fixed by the CFTC at 25% of the estimated deliverable supply. The spot month limit for cash-settled contracts based on the prices of physically-delivered futures contracts would be five times the limit on such contract's physically-delivered counterpart, provided that the trader holds no physically-settled contracts in the spot month. If the trader holds physically-delivered contracts in the spot month, the limit would be equal to the limit on those physically-delivered contracts.

Outside the spot month, the limits in the Referenced Energy Contracts would be set using a two-tiered system:

1. Single-month aggregate and all-months-combined *aggregate* position limits would apply to contracts of the same class of the spot month⁴ across all reporting markets (*i.e.*, exchanges) listing the same Referenced Energy Contracts (including look-alike contracts).
2. Single-month and all-months-combined limits would apply to contracts of the same class of the spot month on a single reporting market.

For contracts traded across all reporting markets listing the same Referenced Energy Contracts, the Proposal fixes the all-months-combined *aggregate* position limit at 10% of the first 25,000 contracts of open interest, with a marginal increase of 2.5% of open interest thereafter. The single-month *aggregate* position limit would be fixed at two-thirds of the all-months-combined aggregate position limit.⁵

The Proposal fixes an all-months-combined position limit for contracts of the same class on the same reporting market at the lower of the all-months-combined *aggregate* position limit (described above) or 30% of a class's single-exchange final open interest value (*i.e.*, the number of open contracts in the same class on the same exchange). The single-month position limit is set at two-thirds of the all-months-combined position limit. The single-month and all-months-

⁴ Contracts of the same class of the spot month include all Referenced Energy Contracts (including option contracts on a futures-equivalent basis) on a single reporting market that are based on the same commodity and settled in the same manner and on the same day.

⁵ The Proposal requires the aggregation of positions in a Referenced Energy Contract's different classes on a single exchange and across exchanges for the purpose of determining compliance with the aggregate all-months-combined and aggregate single-month position limits. Accordingly, no trader would be permitted to hold net long or net short Referenced Energy Contract positions that, when combined with the net long or net short position in the same Referenced Energy Contract on another exchange, would exceed the aggregate all-months-combined and aggregate single-month position limits.

combined limits for contracts of the same class on a single exchange are, however, subject to a minimum position limit equal to the greater of 5,000 contracts or 1% of the aggregated open interest value. This minimum limit is intended to give newly listed contracts or contracts with low open interest the opportunity to attract liquidity.

The CFTC requested comment on alternatives to the proposed levels, including a proposal submitted by The CME Group.

Proposed Exemptions

The Proposal would establish exemptions from the limits described above for:

- (i) *bona fide* hedging transactions;
- (ii) certain swap dealer risk management transactions; and
- (iii) positions that would be in compliance with the limits when adjusted by an appropriate contemporaneous risk factor.

The *bona fide* hedging exemption. As proposed, a reporting market may establish an exemption process that is generally consistent with current CFTC regulations for traders holding positions in proprietary accounts that are shown to be *bona fide* hedging positions. Traders holding positions in excess of the applicable limit pursuant to a *bona fide* hedging exemption would generally be prohibited from also trading speculatively in the spot month. Such a trader would also be prohibited from holding positions as a swap dealer if the trader's *bona fide* hedging positions outside the spot month (i) exceed the applicable speculative position limit and (ii) are more than twice the otherwise applicable all-months-combined or single-month limit. In contrast, however, traders holding positions in the spot month in excess of the applicable limit pursuant to a *bona fide* hedging exemption would be permitted to hold speculative positions outside the spot month.

The swap dealer risk management exemption. Currently, a swap dealer⁶ may exceed position limits in certain commodities if it obtains an exemption from the applicable limits under CFTC regulation 1.3(z). The CFTC has generally granted such relief on a case-by-case basis. The Proposal would eliminate the hedge exemption for swap dealers that are not engaging in *bona fide* hedging transactions. Pursuant to the Proposal's risk management exemption, swap dealers would apply to the CFTC for permission to exceed speculative position limits outside the spot month that are held to manage the risks associated with swap agreements entered into to

⁶ "Swap dealer," as defined in the Proposal, would include any person who, as a significant part of its business, holds itself out as a dealer in swaps, makes a market in swaps, regularly engages in the purchase of swaps and their resale to customers in the ordinary course of business, or engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps. The CFTC's proposed definition of "swap dealer" is substantially similar to the definition of swap dealer in the bill currently before the U.S. House of Representatives Committee on Agriculture that seeks to regulate the OTC derivatives markets, entitled Derivative Markets Transparency and Accountability Act, Amendment to H.R. 4173, 111th Congress, 1st Session (2009).

accommodate swap customers. The swap dealer risk management exemption would be limited to twice the applicable all-months-combined or (non-spot) single-month limit. In addition, swap dealers would be required to aggregate positions held as risk management transactions with net speculative positions for purposes of compliance with the applicable limits. Finally, swap dealers holding positions in excess of the otherwise applicable limit pursuant to a risk management exemption would generally be prohibited from also trading speculatively in the same futures contract.

As a condition of the exemption, swap dealers would be required to consent to having their names published on the CFTC's website once a year beginning at least six months after the swap dealer is granted its initial exemption. Swap dealers would also be required to make monthly filings with the CFTC that demonstrate their continued eligibility for the exemption.

The contemporaneous risk factor exemption. Because option risk factors continuously change with movements in the price of an underlying futures contract, a trader offsetting the risk of an option position through a delta-neutral position in the underlying futures contract may need to adjust the futures position substantially on an intra-day basis to maintain a risk-neutral position. The Proposal sets forth a contemporaneous risk factor exemption for persons whose positions would have exceeded the applicable position limit for a Referenced Energy Contract when adjusted by the previous day's risk factors (deltas), provided that such positions would not exceed the limit when positions are calculated using an appropriate contemporaneous risk factor. The trader must be able to demonstrate that its positions remained within the otherwise applicable limit when adjusted by the appropriate and contemporaneous risk factor.

Account Aggregation

The Proposal would establish account aggregation standards specifically for positions in Referenced Energy Contracts. Positions in accounts in which any person, directly or indirectly, has an interest of 10% or greater or, by power of attorney or otherwise, controls trading would be aggregated with all other positions of that person. The Proposal, however, includes a limited exemption for positions in pools in which a trader that is a limited partner or shareholder has an interest of less than 25% unless the trader in fact controls the trading of that pool. The proposed regulation would also treat positions held by two or more persons acting in concert the same as if the positions were held by a single person. Accordingly, the proposed regulations would aggregate positions in accounts at both the account owner and controller levels.

In contrast to the disaggregation exemptions in CFTC regulations applicable to agricultural commodities, eligible entities (such as mutual funds, commodity pool operators and commodity trading advisors) and futures commission merchants would not be permitted to disaggregate positions pursuant to the independent account controller framework established in the CFTC's Part 150 regulations.

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If you have any questions regarding the content of this memorandum, please contact Rita M. Molesworth (212-728-8727, rmolesworth@willkie.com) or the Willkie attorney with whom you regularly work.

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Appendix A

The CFTC requested comment on all aspects of the Proposal, and in particular, on the following:

1. Are Federal speculative position limits for energy contracts traded on reporting markets necessary to “diminish, eliminate, or prevent” the burdens on interstate commerce that may result from position concentrations in such contracts?
2. Are there methods other than Federal speculative position limits that should be utilized to diminish, eliminate, or prevent such burdens?
3. How should the CFTC evaluate the potential effect of Federal speculative position limits on the liquidity, market efficiency and price discovery capabilities of referenced energy contracts in determining whether to establish position limits for such contracts?
4. Under the class approach to grouping contracts as discussed in the Proposal, how should contracts that do not cash settle to the price of a single contract, but settle to the average price of a sub-group of contracts within a class be treated during the spot month for the purposes of enforcing the proposed speculative position limits?
5. Under proposed regulation 151.2(b)(1)(i), the CFTC would establish an all-months-combined aggregate position limit equal to 10% of the average combined futures and option contract open interest aggregated across all reporting markets for the most recent calendar year up to 25,000 contracts, with a marginal increase of 2.5% of open interest thereafter. As an alternative to this approach to an all-months-combined aggregate position limit, the CFTC requests comment on whether an additional increment with a marginal increase larger than 2.5% would be adequate to prevent excessive speculation in the referenced energy contracts. An additional increment would permit traders to hold larger positions relative to total open positions in the referenced energy contracts, in comparison to the proposed formula. For example, the CFTC could fix the all-months-combined aggregate position limit at 10% of the prior year’s average open interest up to 25,000 contracts, with a marginal increase of 5% up to 300,000 contracts and a marginal increase of 2.5% thereafter. Assuming the prior year’s average open interest equaled 300,000 contracts, an all-months-combined aggregate position limit would be fixed at 9,400 contracts under the proposed rule and 16,300 contracts under the alternative.
6. Should customary position sizes held by speculative traders be a factor in moderating the limit levels proposed by the CFTC? In this connection, the CFTC notes that current regulation 150.5(c) states contract markets may adjust their speculative limit levels “based on position sizes customarily held by speculative traders on the contract market, which shall not be extraordinarily large relative to total open positions in the contract...”
7. Reporting markets that list Referenced Energy Contracts would continue to be responsible for maintaining their own position limits (so long as they are not higher than the limits fixed by the CFTC) or position accountability rules. The CFTC seeks comment on whether it should issue acceptable practices that adopt formal guidelines and procedures for implementing position accountability rules.

8. Proposed regulation 151.3(a)(2) would establish a swap dealer risk management exemption whereby swap dealers would be granted a position limit exemption for positions that are held to offset risks associated with customer initiated swap agreements that are linked to a referenced energy contract but that do not qualify as *bona fide* hedge positions. The swap dealer risk management exemption would be capped at twice the size of any otherwise applicable all-months-combined or single non-spot month position limit. The CFTC seeks comment on any alternatives to this proposed approach. The CFTC seeks particular comment on the feasibility of a “look-through” exemption for swap dealers such that dealers would receive exemptions for positions offsetting risks resulting from swap agreements opposite counterparties who would have been entitled to a hedge exemption if they had hedged their exposure directly in the futures markets. How viable is such an approach given the CFTC’s lack of regulatory authority over the OTC swap markets?
9. Proposed regulation 20.02 would require swap dealers to file with the CFTC certain information in connection with their risk management exemptions to ensure that the CFTC can adequately assess their need for an exemption. The CFTC invites comment on whether these requirements are sufficient. In the alternative, should the CFTC limit these filing requirements, and instead rely upon its regulation 18.05 special call authority to assess the merit of swap dealer risk management exemption requests?
10. The CFTC’s proposed part 151 regulations for Referenced Energy Contracts would set forth a comprehensive regime of position limit, exemption and aggregation requirements that would operate separately from the current position limit, exemption and aggregation requirements for agricultural contracts set forth in part 150 of the CFTC’s regulations. While proposed part 151 borrows many features of part 150, there are notable distinctions between the two, including their methods of position limit calculation and treatment of positions held by swap dealers. The CFTC seeks comment on what, if any, of the distinctive features of the position limit framework proposed herein, such as aggregate position limits and the swap dealer limited risk management exemption, should be applied to the agricultural commodities listed in part 150 of the CFTC’s regulations.
11. The CFTC is considering establishing speculative position limits for contracts based on other physical commodities with finite supply such as precious metal and soft agricultural commodity contracts. The CFTC invites comment on which aspects of the current speculative position limit framework for the agricultural commodity contracts and the framework proposed herein for the major energy commodity contracts (such as proposed position limits based on a percentage of open interest and the proposed exemptions from the speculative position limits) are most relevant to contracts based on other physical commodities with finite supply such as precious metal and soft agricultural commodity contracts.

12. As discussed previously, the CFTC has followed a policy since 2008 of conditioning Foreign Board of Trade (“FBOT”) no-action relief on the requirement that FBOTs with contracts that link to CFTC-regulated contracts have position limits that are comparable to the position limits applicable to CFTC-regulated contracts. If the CFTC adopts the proposed rulemaking, should it continue, or modify in any way, this policy to address FBOT contracts that would be linked to any referenced energy contract as defined by the proposed regulations?
13. The CFTC notes that Congress is currently considering legislation that would revise the CFTC’s section 4a(a) position limit authority to extend beyond positions in reporting market contracts to reach positions in OTC derivative instruments and FBOT contracts. Under some of these revisions, the CFTC would be authorized to set limits for positions held in OTC derivative instruments and FBOT contracts.¹ The CFTC seeks comment on how it should take this pending legislation into account in proposing Federal speculative position limits.
14. Under proposed regulation 151.2, the CFTC would set spot month and all-months-combined position limits annually.
 - a. Should spot month position limits be set on a more frequent basis given the potential for disruptions in deliverable supplies for referenced energy contracts?
 - b. Should the CFTC establish, by using a rolling-average of open interest instead of a simple average for example, all-months-combined position limits on a more frequent basis? If so, what reasons would support such action?
15. Concerns have been raised about the impact of large, passive, and unleveraged long-only positions on the futures markets. Instead of using the futures markets for risk transference, traders that own such positions treat commodity futures contracts as distinct assets that can be held for an appreciable duration. The Proposal does not propose regulations that would categorize such positions for the purpose of applying different regulatory standards. Rather, the owners of such positions are treated as other investors that would be subject to the proposed speculative position limits.
 - a. Should the CFTC propose regulations to limit the positions of passive long traders?
 - b. If so, what criteria should the CFTC employ to identify and define such traders and positions?

¹ See, e.g., the Over-the-Counter Derivatives Markets Act of 2009 (“OCDMA”), H.R. 3795, 111th Congress, 1st Session (2009). The OCDMA would also eliminate the Derivatives Transaction Execution Facility, Exempt Commercial Market and Exempt Commercial Market-Significant Price Discovery Contract market categories.

- c. Assuming that passive long traders can properly be identified and defined, how and to what extent should the CFTC limit their participation in the futures markets?
 - d. If passive long positions should be limited in the aggregate, would it be feasible for the CFTC to apportion market space amongst various traders that wish to establish passive long positions?
 - e. What unintended consequences are likely to result from the CFTC's implementation of passive long position limits?
16. The proposed definition of referenced energy contract, diversified commodity index, and contracts of the same class are intended to be simple definitions that readily identify the affected contracts through an objective and administrative process without relying on the CFTC's exercise of discretion.
- a. Is the proposed definition of contracts of the same class for spot and non-spot months sufficiently inclusive?
 - b. Is it appropriate to define contracts of the same class during spot months to only include contracts that expire on the same day?
 - c. Should diversified commodity indexes be defined with greater particularity?
17. Under the proposed regulations, a swap dealer seeking a risk management exemption would apply directly to the CFTC for the exemption. Should such exemptions be processed by the reporting markets as would be the case with *bona fide* hedge exemptions under the proposed regulations?
18. In implementing initial spot month speculative position limits, if the notice of proposed rulemaking is finalized, should the CFTC:
- a. Issue special calls for information to the reporting markets to assess the size of a contract's deliverable supply;
 - b. Use the levels that are currently used by the exchanges; or
 - c. Undertake an independent calculation of deliverable supply without substantial reliance on exchange estimates?