

CLIENT MEMORANDUM

CFTC Reproposes Position Limit Regulations

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The Commodity Futures Trading Commission has voted unanimously to repropose rules to amend Part 150 of the CFTC's regulations relating to speculative position limits (the "Reproposal").¹ The Reproposal replaces a prior proposal published in December 2013 (the "December 2013 Proposal"), and a supplement to the December 2013 Proposal published in June 2016. The Reproposal states that, if adopted, the compliance date for the new rules would be no earlier than January 3, 2018.

CFTC rules currently establish speculative position limits on certain agricultural commodity futures and options contracts. The Reproposal seeks to establish limits for speculative positions on 25 exempt and agricultural commodity futures and options contracts ("Core Referenced Contracts"),² and swaps that are economically equivalent to those contracts (together with the Core Referenced Contracts, the "Referenced Contracts").³

¹ *Position Limits for Derivatives* available at <http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/federalregister120516.pdf>. The CFTC has also finalized rules regarding the aggregation of positions which we address in a separate client memorandum, available [here](#).

² The contracts, categorized by exchange, are: (i) Chicago Board of Trade: Corn, KC HRW Wheat, Oats, Rough Rice, Soybeans, Soybean Meal, Soybean Oil, and Wheat; (ii) Chicago Mercantile Exchange ("CME"): Live Cattle; (iii) COMEX: Copper, Gold, and Silver; (iv) ICE Futures: Cocoa,

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If adopted, the Reproposal, among other things, would also: (i) implement requirements and acceptable practices for Designated Contracts Markets (“DCM”) and Swap Execution Facilities (“SEF”) for setting position limits for Referenced Contracts and other contracts; (ii) add certain definitions, including the definition of a “bona fide hedging position”; and (iii) permit market participants to apply for additional exemptions from position limits, including for non-enumerated bona fide hedging positions (“NEBFH”).

I. Speculative Position Limits

Spot Month Position Limits

The Reproposal would require that spot month positions, net long or net short, in physically delivered and linked cash settled Referenced Contracts be separately calculated. The CFTC would review the position limits at least every two years, but would not necessarily revise the levels. The Reproposal would generally set federal position limits as follows:

1. Legacy agricultural contracts: Spot month limits, generally, would be set at the levels recommended by CME or Minneapolis Grain Exchange, Inc., as applicable, each of which is below 25% of estimated deliverable supply.
2. Other agricultural contracts: Spot month limits, generally, would be set at 25% of estimated deliverable supply.
3. Metals: Spot month limits would be set at the recommended levels submitted by CME, all of which are below 25% of estimated deliverable supply.
4. Energy: Spot month limits would be set at 25% of estimated deliverable supply, which for most of the energy contracts would be higher than the corresponding levels recommended by CME.

Coffee C, Cotton No. 2, FCOJ-A, Sugar No. 11, and Sugar No. 16; (v) Minneapolis Grain Exchange: Hard Red Spring Wheat; and (vi) NYMEX: Henry Hub Natural Gas, Light Sweet Crude Oil, NY Harbor ULSD, Palladium, Platinum, and RBOB Gasoline. The Reproposal deferred establishing position limits with respect to three cash settled core referenced futures contracts included in the December 2013 Proposal (CME Class III Milk, CME Feeder Cattle, and CME Lean Hogs).

³ In order to be deemed “economically equivalent” to a particular Core Referenced Contract, a contract must be (i) directly or indirectly linked, including being partially or fully settled on, or priced at a fixed differential to, the price of that particular Core Referenced Contract; or (ii) directly or indirectly linked, including being partially or fully settled on, or priced at a fixed differential to, the price of the same commodity underlying that particular core referenced futures contract for delivery at the same location or locations as specified in that particular core referenced futures contract.

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Single Month or All Months Combined Position Limits (“Non-Spot Month”)

The Reproposal would require the netting of all non-spot month positions in Referenced Contracts regardless of whether the contracts are physically delivered or cash settled. Generally, no person would be permitted to hold or control a position in the same commodity either on an all months combined (including the spot month) basis or in a single month in excess of 10% of the estimated average open interest in a Referenced Contract, up to 25,000 contracts, with a marginal increase of 2.5% of the open interest thereafter. Certain exceptions would exist.⁴ As with the spot month limits, the CFTC would review these position limits at least every two calendar years, but need not necessarily revise the levels.

Position Accountability

Since the 1990s, DCMs have been permitted to adopt position accountability levels, in lieu of hard position limits outside the spot month for certain futures contracts. It is important to note that, while the Reproposal provides a framework for a DCM or SEF to set position accountability levels, accountability levels will be permitted *only* for certain contracts not subject to federal position limits.

II. Implications for DCMs and SEFs

The Reproposal would dictate certain requirements and acceptable practices for DCMs and SEFs to implement position limits in Referenced Contracts. For example, a DCM or SEF would generally be required to establish spot month and non-spot month position limits for Referenced Contracts at levels no higher than the corresponding federal limits. However, the Reproposal would delay the implementation of DCM and SEF-set limits for swaps if the relevant DCM or SEF possesses insufficient swap position information. Once the particular DCM or SEF obtains sufficient swap position information, it would be required to establish and impose limits with respect to relevant contracts. With respect to non-Referenced Contracts, including excluded commodities, the Reproposal outlines certain requirements and acceptable practices for establishing position limits and complying with statutory mandates (i.e., DCM Core Principle 5 and SEF Core Principle 6). For example, as noted, the Reproposal would permit DCMs and SEFs to set position accountability levels for certain contracts. The Reproposal would also delegate to DCMs and SEFs the authority to grant to traders certain exemptions from the limits.

III. Exemptions

The Reproposal includes exemptions from federal and DCM and SEF-set limits in certain circumstances. These exemptions would apply to certain positions such as: (i) bona fide hedging positions; (ii) spread positions; and (iii) certain financial distress positions, pre-enactment and transition period swaps, and conditional spot month limit positions.

⁴ For the Hard Red Winter Wheat and Hard Red Spring Wheat contracts, the Reproposal would set the limit at 12,000 contracts rather than applying the formula.

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Bona Fide Hedging Exemption

The Reproposal would amend the CFTC's Part 150 rules to include a definition of "bona fide hedging position" for purposes of exempting such positions from the speculative limits.

"Bona fide hedging position" with respect to physical commodities would, subject to certain conditions, effectively exempt: (i) eight enumerated bona fide hedging positions;⁵ (ii) offsets of pass through swaps; (iii) cross-commodity hedges; (iv) NEBFHs recognized by a DCM or SEF; and (v) offsets of commodity trade options. For derivatives contracts based on excluded commodities, the Reproposal would also define a bona fide hedge as a position that is either (A) an enumerated position that is economically appropriate to the reduction of risk in the conduct and management of a commercial enterprise or (B) recognized by the relevant DCM or SEF as a bona fide hedging position pursuant to such market's rules submitted to the CFTC, which rules may include risk management exemptions consistent with guidelines provided in an appendix to the Reproposal.

The Reproposal provides an appendix containing a non-exhaustive list of examples of positions which would satisfy the reproposed definition of a bona fide hedge for physical commodities.

Recognition of Non-Enumerated Bona Fide Hedges and Anticipatory Hedges by DCMs and SEFs

Under the December 2013 Proposal, a market participant engaging in risk reducing positions not enumerated in the definition of "bona fide hedging position" would have been required to apply for an interpretive letter under CFTC Rule 140.99 or exemptive relief under Section 4a(a)(7) of the Commodity Exchange Act (the "CEA"). Under the Reproposal, a DCM or SEF could submit to the CFTC rules authorizing the qualified trading facility to provide position limit exemptions for NEBFHs as well as for enumerated anticipatory hedges.⁶

The Reproposal would permit a DCM or SEF to adopt rules providing for the recognition of NEBFHs or anticipatory enumerated hedges provided that:⁷

- the position is in a commodity derivative contract that is a Referenced Contract;

⁵ The eight positions are: (1) hedges of inventory and cash commodity purchase contracts; (2) hedges of cash commodity sales contracts; (3) hedges of unfilled anticipated requirements; (4) hedges by agents; (5) hedges of unsold anticipated production; (6) hedges of offsetting unfixed price cash commodity sales and purchases; (7) hedges of anticipated royalties; and (8) hedges of services.

⁶ The enumerated anticipatory hedges are proposed to be: (i) unfilled anticipated requirements; (ii) unsold anticipated production; (iii) anticipated royalties; (iv) anticipated service contract payments or receipts; and (v) anticipatory cross-commodity hedges.

⁷ The Reproposal would not permit a DCM or SEF to recognize an NEBFH involving a commodity index contract and one or more Referenced Contracts.

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- the DCM or SEF lists such contract for trading;
- such contract is actively traded on the DCM or SEF;
- the DCM or SEF has established position limits for such contract; and
- the DCM or SEF has had at least one year of experience administering exchange-set position limits for a Referenced Contract in a particular commodity.⁸

Prior to recognizing any NEBFH, the relevant DCM or SEF would have to obtain from the applicant information regarding the facts and circumstances surrounding the position, including, at a minimum:⁹

- a description of the applicant's position in the relevant contract and offsetting cash positions;
- details to demonstrate why the position satisfies the CEA requirements with respect to bona fide hedging positions and the CFTC's definition of that term;
- a statement concerning the maximum size of all gross positions in derivative contracts for which the application is submitted (based on a good faith estimate);
- information regarding the applicant's cash market activity in the underlying commodity for the past year; and
- any other information necessary for the DCM or SEF to determine whether to recognize the position as an NEBFH.

Each application for recognition of an enumerated anticipatory hedge would have to include the information required under proposed Rule 150.7(d), which generally requires certain details regarding the applicant's utilization of the anticipatory exemption.

A DCM or SEF would generally have to make a determination on an application in a timely manner.¹⁰ If a DCM or SEF recognized a hedge position as bona fide, the market participant would be required to reapply for the exemption at least annually. The CFTC would retain authority to review any determination made by a DCM or SEF, and may require

⁸ The Reproposal clarifies that this requirement could be satisfied through the relevant experience of the surveillance staff regarding the particular commodity.

⁹ The Reproposal would permit a somewhat less involved application process for any NEBFH that is substantially similar to a position that the DCM or SEF has previously recognized as an NEBFH.

¹⁰ For enumerated anticipatory bona fide hedging positions, the DCM or SEF generally would be required to notify the applicant of its determination within 10 days of receipt of the application.

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liquidation of the position (or otherwise require the applicant to come into compliance) within a commercially reasonable amount of time if the CFTC disagreed with the determination of the DCM or SEF.

Spread Positions

Most trading facilities have rules in place to recognize spread transaction exemptions from position limits established by the relevant exchange. Under the Reproposal, a DCM or SEF would also have the opportunity to grant exemptions from federal position limits for certain spread positions, including in the spot month. In so doing, the Reproposal would require the relevant DCM or SEF to consider certain policy objectives.¹¹ In order to process applications related to this exemption, a DCM or SEF must satisfy certain requirements which are generally similar to those required for a DCM or SEF to be eligible to recognize NEBFHs and enumerated anticipatory hedges, as described above.

Applicants would be required to submit to the relevant DCM or SEF information similar to that which would be required from applicants seeking recognition of NEBFHs. For example, each applicant generally would have to (i) describe the spread position for which an exemption is requested; (ii) explain why the spread position should be exempted from position limits; and (iii) provide a statement concerning the maximum size of all gross positions in derivative contracts for which the application was submitted. As with determinations made regarding NEBFHs and anticipatory bona fide hedge positions, spread position exemptions granted by a DCM or SEF would remain subject to CFTC review.

Other Exemptions

The Reproposal provides an exemption for market participants in financial distress circumstances upon the CFTC's approval of a specific request. Examples of such circumstances include the potential default or bankruptcy of a customer, an affiliate or a potential acquisition target of the requesting person(s).

The Reproposal also generally provides an exemption from position limits for swaps entered into in good faith prior to July 21, 2010 (the terms of which have not expired as of that date) through 60 days after the publication of final position limit rules in the *Federal Register*. These swaps would be permitted to be netted with post-effective date positions for purposes of complying with any non-spot month speculative limit.

The Reproposal would permit a trader to have a position greater than the federal limit in cash settled natural gas contracts, provided the trader does not hold or control positions in spot month physical delivery natural gas Referenced Contracts.

¹¹ These policy objectives, which are set forth in Section 4a(a)(3)(B) of the CEA, are: (i) diminishing, eliminating or preventing excessive speculation; (ii) deterring and preventing market manipulation, squeezes and corners; (iii) ensuring sufficient market liquidity for bona fide hedgers; and (iv) ensuring that the price discovery function of the underlying market is not disrupted.

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Reporting and Recordkeeping Requirements

The Reproposal would amend the CFTC's Part 19 rules generally to extend reporting requirements to any person claiming an exemption from federal position limits. In addition, market participants would have to maintain appropriate records supporting their ability to rely on exemptions.

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