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CLIENT ALERT

Take It to the (Speculative) Limit – The CFTC Re-Proposes Speculative Position Limits

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On January 30, 2020, the Commodity Futures Trading Commission voted to issue a proposed rule that would impose federal limits on speculative trading in the agricultural, energy and precious metals commodity derivatives markets. Although the proposal includes an extended 90-day comment period, there are multiple signs that the CFTC intends to move quickly from a proposed rule to a final rule, and the CFTC has made clear that it intends to adopt a final rule sometime this year. Certain aspects of the proposed position limits rule are consistent with the many prior CFTC position limit proposals. However, a number of the key provisions are radically different.

The summary below is designed to assist clients with understanding the scope of the proposed rule, and to begin to assess the impact if the proposed rule becomes final. We expect that the proposed rule will impact most market participants. However, the size of the impact and the issues of concern will vary depending on how each market participant uses the affected contracts. For example, the rule impacts dealers differently from companies that use the markets primarily to speculate on changes in commodity prices. For commercial end-users, the rule impacts those that hedge primarily with swaps differently from those that hedge with both futures and swaps.

Because we expect the CFTC to move quickly to adopt a final rule, assessing the impact of the proposed rule on your particular business should prove useful with subsequent efforts to comply with the rule once it becomes final.

What are speculative position limits? Limits on the number of derivative positions a person can own or control absent an exemption.

Historically, the CFTC and futures exchanges have set limits on the number of speculative *futures* positions that a person can own or control. The limits applied to a particular futures contract, and all futures positions in the contract were considered speculative unless an exemption was available. If a person exceeded a limit without an exemption, it was a violation of CFTC and futures exchange rules regardless of the surrounding facts and circumstances. Prior to the latest proposal, the CFTC imposed limits on nine agricultural futures contracts, and the futures exchanges established limits across listed futures contracts.

Under the current proposal, and as described in greater detail below, the CFTC proposes spot month limits across 25 core referenced futures contracts, and also proposes non-spot month limits (single month and all-months combined limits) for the nine legacy agricultural futures contracts. The list of core referenced futures contracts and the proposed federal limits are summarized in Appendices 1 and 2. Furthermore, the federal limits would no longer apply only to a particular futures contract, but would apply to the futures contract along with cash-settled futures and economically equivalent swaps.

What derivatives contracts would be subject to federal limits? Futures and a narrow group of swaps.

The proposal identifies 25 physical commodity futures contracts that would be subject to federal limits. The CFTC refers to the 25 futures contracts as "**core referenced futures contracts**" or "**CRFCs**," and these futures contracts set the baseline for other derivative products subject to limits. For each of the 25 contracts, the proposal would also impose limits on (1) cash-settled futures contracts that are directly or indirectly linked to one of the 25 contracts; and (2) swaps that are economically equivalent to a core referenced futures contract or cash-settled futures that are subject to federal limits. The collective term for derivatives subject to federal limits is "**referenced contracts**."

According to the preamble to the proposal, the CFTC intends to publish a workbook summarizing the cash-settled futures contracts that would be subject to limits. However, the workbook would not address the swaps that are economically equivalent to a derivative contract subject to federal limits. In evaluating the impact of the proposed rule, firms should assess whether they trade the 25 core referenced futures contracts, cash-settled futures that are directly or indirectly linked to the core referenced futures contracts, or swaps that are economically equivalent to a referenced contract subject to federal limits.

As proposed, the scope of swaps that would be subject to federal limits is much narrower than in prior CFTC proposals. For a swap to be economically equivalent, it must have "material" terms identical to a contract subject to federal limits. Examples of material terms include the underlying commodity referenced in the swap and the settlement type (cash-settled or physical delivery). In a major change from the prior proposals, the fact that a cash-settled swap is priced by reference to a core referenced futures contract means that it would *not* be subject to federal limits because the settlement type is different (cash-settled swaps versus physical delivery futures). This may greatly reduce the population of swaps that would be subject to federal limits.

One of the main consequences of a derivative contract being subject to federal limits is that limits apply on a net basis. This means that one long and one short contract subject to limits count as a net zero position when measuring compliance with a speculative position limit. However, if one long contract is subject to limits, and one short contract is not subject to limits, then the resulting position is one long position when measuring compliance with a speculative position limit. Consequently, firms should consider the impact of the futures and swaps that are subject to limits (or not), and the size of their positions after netting.

What are the federal limits? Spot month limits for energy, metals, and agricultural contracts, and non-spot month limits for nine agricultural contracts.

The CFTC proposes to impose spot month position limits for all 25 core referenced futures contracts and related referenced contracts. The length of the spot month varies by type of core referenced futures contract, but at a high level, the spot month starts near in time to the final settlement of a futures contract. The proposed spot month limits would impose one limit for physically settled referenced contracts, such as CRFCs, and a separate limit for cash-settled referenced contracts, such as cash-settled futures referenced contracts and economically equivalent swaps. For example, the spot month limit for the COMEX gold futures contract is 6,000, so a participant could own up to 6,000 speculative long/short positions in the COMEX gold physical delivery futures contract, and separately hold up to 6,000 speculative long/short positions in cash-settled referenced contracts.

Although the spot month limits are generally the same for physical delivery and cash-settled referenced contracts, the CFTC again proposed the concept of a “conditional” spot month limit for the natural gas referenced contracts. Under the proposed conditional limit, as long as a company does not hold a position in the physically delivered NYMEX Henry Hub futures contract, then it could hold up to 10,000 cash-settled futures equivalent contracts per futures exchange, and up to 10,000 futures equivalent swaps that are referenced contracts. Without the conditional limit, the limit for cash-settled natural gas referenced contracts would be only 2,000 futures equivalent contracts combined across cash-settled futures and economically equivalent swaps.

The CFTC also proposes to impose single month and all-months combined limits for the nine legacy agricultural contracts. Unlike spot month limits, the proposed non-spot month limits apply collectively to physical delivery and cash-settled referenced contracts. For example, one long position in a physical delivery future, and one short position in a cash-settled swap count as a net zero position for federal non-spot month limits. In a significant departure from prior proposals, the CFTC would not impose non-spot month limits on the remaining 16 core referenced futures contracts and their related referenced contracts.

What exemptions are available from speculative position limits? *Bona fide* hedge exemptions, spread exemptions, the pass-through swap exemption, and financial distress exemptions.

The proposed rule continues to provide that *bona fide* hedging positions and spread positions are exempt from federal position limits. Unlike prior proposals, the current proposed definition of *bona fide* hedging transaction appears to accommodate more end-users hedging physical commodity price risk. The proposal retains the structure in which there is a general definition of *bona fide* hedging along with a list of specifically enumerated hedging strategies that qualify as a *bona fide* hedge. Compared to prior proposals, the proposed general definition of *bona fide* hedging transaction provides greater flexibility in accommodating hedging programs that are managed on a net or gross basis, by region, or otherwise customized. In addition, the CFTC's list of specifically enumerated hedging transactions is more extensive than in prior proposals, including the addition of an enumerated hedge for anticipatory merchandising.

The proposal also lists specific spread transactions that are exempt from federal limits. These spread strategies include calendar spreads, inter-commodity spreads, quality differential spreads, processing spreads, product or by-product differential spreads, and futures-options spreads.

Similar to prior proposals, the proposed rule includes the so-called "pass-through swap" exemption, which provides an exemption for participants that execute swaps with a counterparty using the swap as a *bona fide* hedge. For example, a swap dealer executing a swap with an end-user that, in turn, is hedging price risk associated with production can avail itself of the pass-through swap exemption. The exemption is available provided the participant not only executes a swap with a *bona fide* hedger, but also lays off the risk of the swap with offsetting referenced contracts. Finally, the proposed rule incorporates a financial distress exemption that addresses trading related to specific scenarios, such as a potential default or bankruptcy of a customer or potential acquisition target.

If a hedging strategy is not on the CFTC's enumerated list of *bona fide* hedge positions, can it still qualify as a *bona fide* hedge? Yes, there is a proposed process to apply to a futures exchange or the CFTC.

If a hedging strategy is not on the list of enumerated hedging strategies, the proposed rule includes a process to apply to recognize the hedges as *bona fide* hedging positions. A participant could apply to the CFTC, or alternatively, the proposed rule authorizes futures exchanges to grant non-enumerated *bona fide* hedging exemptions subject to a CFTC ten-day review process. In general, participants must receive a non-enumerated hedge exemption prior to exceeding a limit, but the proposal also incorporates a specialized and streamlined application process if a participant exceeds a limit due to sudden or unforeseen hedging needs in which case the exemption is subject to a two-day CFTC review process. To the extent a person receives a non-enumerated hedge exemption from the exchange, and the CFTC does not object to the exemption, the exemption would be valid after the applicable CFTC review period provided the participant re-applies to the exchange on an annual basis.

If a firm is relying upon an exemption from federal limits, are there forms that need to be filed with the CFTC? No, the CFTC proposed to replace the form filing requirement with an application process to the exchange.

In a significant departure from prior position limit proposals, the CFTC proposed to eliminate the form filing requirements for market participants relying upon exemptions from federal limits (*i.e.* Forms 204, 304, 504, 604, and 704). These forms could have presented significant compliance burdens for many market participants, so the proposed elimination of these forms should be a welcome development for the industry.

In lieu of the forms, the CFTC proposes that market participants under certain circumstances would need to file an application for an exemption with a futures exchanges. When applying to a futures exchange, a participant would need to detail the basis for an exemption. In addition, market participants would be subject to recordkeeping requirements, including the ability to demonstrate that positions in a referenced contact are eligible for an exemption.

Are hedges of financial exposure eligible for an exemption? No.

Similar to prior proposals, the proposed rules do not establish a risk management exemption related to hedging financial exposure. Furthermore, the CFTC proposes to eliminate any risk management exemptions previously granted to market participants.

The lack of a risk management exemption will likely impact liquidity providers the most, but it may also have the unintended consequence of reducing liquidity for commercial end-users. An area of particular interest is for dealers that provide customers with access to commodity index exposure in the form of commodity index swaps or commodity linked notes. Although commodity index contracts or commodity linked notes would not be subject to federal limits, if the dealer hedges its exposure with individual futures contracts that are subject to federal limits, then the futures positions would count toward a position limit without any recognition that those futures positions hedge other financial exposure. This proposed framework effectively caps a single dealer’s ability to provide customers with liquidity in commodity index swaps.

The CFTC believes that higher non-spot speculative position limits for the nine legacy agricultural contracts will allow dealers to conduct financial risk management activity under a speculative position limit. Furthermore, by not proposing non-spot month limits on energy, metals and certain agricultural commodity contracts, the CFTC believes that dealers should be able to hedge financial exposure with those contracts without exceeding speculative position limits. Firms should evaluate how helpful the higher limits and lack of certain non-spot month limits are when assessing the impact of a lack of a risk management exemption.

When would a firm need to comply with a final position limits rule? One year after the adoption of the final rule.

Although the CFTC may move quickly to adopt a final rule, the CFTC proposes a one-year transition period after adoption of the final rule whereby market participants would have one-year to come into compliance with the final rule. The proposal also incorporates additional exemptions for positions established prior to the adoption of the final rule in order to provide for a smooth transition for compliance with federal limits.

Appendix 1. Federal Spot Month Limits

Core Referenced Futures Contract	2020 Proposed Spot Limit	Existing Federal Spot Limit
Legacy Agricultural Contracts		
CBOT Corn (C)	1,200	600
CBOT Oats (O)	600	600
CBOT Soybeans (S)	1,200	600
CBOT Soybean Meal (SM)	1,500	720
CBOT Soybean Oil (SO)	1,100	540
CBOT Wheat (W)	1,200	600
CBOT KC HRW Wheat (KW)	1,200	600
MGEX HRS Wheat (MWE)	1,200	600
ICE Cotton No. 2 (CT)	1,800	300

Other Agricultural Contracts		
CME Live Cattle (LC)	600/300/200[1]	n/a
CBOT Rough Rice (RR)	800	n/a
Ice Cocoa (CC)	4,900	n/a
Ice Coffee C (KC)	1,700	n/a
ICE FCOJ-A (OJ)	2,200	n/a
ICE U.S. Sugar No. 11 (SB)	25,800	n/a
ICE U.S. Sugar No. 16 (SF)	6,400	n/a
Metal Contracts		
COMEX Gold (GC)	6,000	n/a
COMEX Silver (SI)	3,000	n/a
COMEX Copper (HG)	1,000	n/a
NYMEX Platinum (PL)	500	n/a
NYMEX Palladium (PA)	50	n/a
Energy Contracts		
NYMEX Light Sweet Crude Oil (CL)	6,000/5,000/4,000[2]	n/a

[1] The proposed federal spot month limit for Live Cattle would feature a step-down limit whereby: (1) 600 at the close of trading on the first business day following the first Friday of the contract month; (2) 300 at the close of trading on the business day prior to the last five trading days of the contract month; and (3) 200 at the close of trading on the business day prior to the last two trading days of the contract month.

[2] The WTI limit would feature a step-down limit whereby the limit would be: (1) 6,000 contracts as of the close of trading three business days prior to the last trading day of the contract; (2) 5,000 contracts as of the close of trading two business days prior to the last trading day of the contract; and (3) 4,000 contracts as of the close of trading one business day prior to the last trading day of the contract.

NYMEX NYH ULSD Heating Oil (HO)	2,000	n/a
NYMEX NYH RBOB Gasoline (RB)	2,000	n/a
NYMEX Henry Hub Natural Gas (NG)	2,000	n/a

Appendix 2. Federal Non-spot Month Limits

Core Referenced Futures Contract	2020 Proposed Single Month and All-Months Combined Limit	Existing Federal Single Month and All-Months-
CBOT Corn (C)	57,800	33,000
CBOT Oats (O)	2,000	2,000
CBOT Soybeans (S)	27,300	15,000
CBOT Soybean Meal (SM)	16,900	6,500
CBOT Soybean Oil (SO)	17,400	8,000
CBOT Wheat (W)	19,300	12,000
CBOT KC HRW Wheat (KW)	12,000	12,000
MGEX HRS Wheat (MWE)	12,000	12,000
ICE Cotton No. 2 (CT)	11,900	5,000

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