MEMO# 25610

November 3, 2011

CFTC Issues Final Rule on Position Limits

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 44-11
SEC RULES COMMITTEE No. 96-11 RE: CFTC ISSUES FINAL RULE ON POSITION LIMITS

The Commodity Futures Trading Commission ("Commission" or "CFTC") recently adopted a rule regarding position limits for futures and swaps, pursuant to Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"). [1] Among other things, the final rule (i) establishes position limits for 28 commodity and options contracts and commodity swaps that are economically equivalent to those contracts; (ii) imposes an aggregation framework for certain entities and accounts; and (iii) provides exemptions from the limits for enumerated bona fide hedging transactions. A brief summary of the rule and Commissioner Scott O'Malia's dissent are provided below. [2]

I. Key Rule Components

The final rule includes the following principal components.

A. Contracts Subject to Position Limits

The final rule establishes position limits for 28 physical commodity futures and option contracts ("Core Referenced Futures Contracts") [3] and swaps that are economically equivalent to such contracts (collectively, "Referenced Contracts"). A futures contract or swap is "economically equivalent" if it is (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.

In addition to the Core Referenced Futures Contracts, Referenced Contracts include: (i) contracts that settle off of the Core Referenced Futures Contracts and contracts that are based on the same commodity for the same delivery location as the Core Referenced Futures Contract (also called "look-alike" contracts); (ii) contracts with a referenced price based only on the combination of at least one Referenced Contract price and one or more prices in the same or substantially the same commodity as that underlying the relevant Core Referenced Futures Contract; and (iii) intercommodity spreads with two components, at least one of which is a Referenced Contract. Non-spot month position limits do not apply to futures, options and swaps entered in good faith prior to the effective date of the rule, and position limits do not apply to swaps entered before the Dodd-Frank Act's effective date. [4]

B. Spot-Month Limits and Phased Implementation

The Commission intends to implement the new position limits in two phases. In the first phase, the spot-month limits for Referenced Contracts will be set at a level based on existing Commission limits for the nine legacy agricultural commodities and limits determined by the designated contract market ("DCM") for the other Referenced Contracts. In the second phase, spot-month limits will be adjusted on a regular schedule, set to 25 percent of the Commission's determination of estimated deliverable supply (except as described below), which will be based on DCM-provided estimates or the Commission's own estimates. [5] The spot-month position limits will apply separately for physically-delivered contracts and cash-settled contracts; a trader may hold positions up to the spot-month position limit in both physical-delivery and cash-settled contracts but may not net cash-settled contracts with physical-delivery contracts. As an interim final rule, the Commission will apply spot-month position limits for cash-settled contracts using the same methodology as applied to physical-delivery Core Referenced Futures Contracts (with the exception of natural gas contracts). The Commission will be seeking additional comments on the appropriate level of spot-month position limits for cash-settled contracts. [6]

C. Non-Spot-Month Limits

The final rule includes a non-spot-month position limit based on the total open interest for all Referenced Contracts in a commodity. For non-legacy Referenced Contracts, the position limit is set at 10 percent of the first 25,000 contracts of average all-months-combined aggregate open interest with a 2.5 percent increase thereafter. Single month position limit levels will be at the same levels as the all-months combined limits. The non-spot month limits will become effective on the first calendar day of the third calendar month after the Commission publishes the initial-non-spot month limits (which will follow after the Commission collects sufficient data to determine average all-months-combined aggregate open interest for a full 12-month period). [7]

For legacy Referenced Contracts, the Commission adopted position limits at levels proposed by the Chicago Board of Trade. These limits will become effective sixty days after the term "swap" is further defined by the Commission and the Securities and Exchange Commission.

Acknowledging that Congress recognizes an "inherent uncertainty" regarding future effects associated with methods for setting position limits, the Commission explained in the Release that it will perform a study evaluating the effects of the position limits on excessive speculation and on the movement of transactions from DCMs to foreign venues. The Commission stated that it may, if warranted, revise the methodology for setting non-spot position limits.

D. Intraday Compliance with Position Limits

The final rule requires intraday compliance with position limits.

E. Bona Fide Hedging

The final rule defines "bona fide hedging transactions or positions" similarly to the definition found in Rule 1.3(z) under the Commodity Exchange Act ("CEA") except for two important distinctions. First, the final rule narrows the definition of bona fide hedging to cover only transactions or positions that represent a substitute for a physical market transaction. Second, a transaction will qualify as bona fide hedging so long as either (i) the counterparty to the swap qualifies for a bona fide hedging transaction exemption or (ii) the swap satisfies the requirements of a bond fide hedging transaction. Importantly, a transaction may now qualify as a bona fide hedging transaction irrespective of whether the hedger's position would otherwise exceed applicable position limits. [8]

The final rule exempts eight different categories of hedging transactions from position limits ("enumerated hedges"), including certain sales, purchases, and offsetting sales and purchases of Referenced Contracts that do not exceed defined quantities, as well as anticipated merchandising hedges, anticipated royalty hedges, service hedges, and cross-commodity hedges. The Commission provides examples of transactions satisfying the bona fide hedging exemptions in Appendix B of the Release. In addition, market participants may request interpretive guidance regarding whether a transaction or class of transactions qualifies as an enumerated hedge under the new rule and may petition the Commission to amend the list of enumerated hedges or definition of these hedges.

The Commission declined to include a risk management provision in the general definition of bona fide hedging. It also clarified that bona fide hedging has different meanings for purposes of the end user exception and the definition of major swap participant than for the general definition of bond fide hedging in Section 4a(c)(2) of the CEA. Further, the Commission clarified that the definition of "bona fide hedging" in Rule 1.3(z) would be retained only for excluded commodities. Finally, the Commission stated that it would continue to recognize prior determinations of bona fide hedging under Rule 1.3(z) even though it is eliminating the application process to seek such exemptions for non-enumerated transactions or positions under Rule 1.3(z)(3).

Parties that exceed position limits are required to submit reports regarding their hedging transactions. Under the final rule, a trader must file a Form 404 three business days after the day that a position limit is exceeded; thereafter the trader must file daily data on a monthly basis. The reports are to include cash market positions for each day that the trader exceeded the position limits during the monthly reporting period. The final rule also requires traders engaging in anticipatory merchandising hedges, anticipated royalty hedges, and service hedges to file Form 404A at least 10 business days before the date of the transactions or positions that would result in exceeding a position limit.

F. Financial Distress Exemption

The final rule provides for a "financial distress exemption" upon request to the Commission in circumstances involving potential default or bankruptcy.

G. Aggregation of Accounts

The final rule largely retains the current pool aggregation standards, including a revised version of the independent account controller ("IAC") exemption, and the current ownership and control standards. The rule's aggregation structure includes the following components:

1. Overall Aggregation Requirements

Under the final rule, a trader will be required to:

- aggregate all positions in accounts in which the trader, directly or indirectly, holds an ownership or equity interest of 10 percent or more, as well as accounts over which the

trader directly or indirectly controls trading;
- aggregate interests in funds or accounts with identical trading strategies; and
- aggregate any positions in multiple accounts or pools, including passively-managed index funds, if those accounts or pools have identical trading strategies.

The rule also aggregates positions held by two or more traders acting pursuant to an express or implied agreement.

2. Independent Account Controller Exemption

As noted above, the final rule provides an IAC exemption similar to that currently available, with the revised rule explicitly limiting the exemption to client positions where the trader has a fiduciary relationship to those for whom he or she trades. Under the IAC exemption, “eligible entities,” which include mutual funds, banks, commodity pool operators, commodity trading advisors, and insurance companies, may disaggregate customer positions or accounts managed by an IAC from proprietary positions if the IAC trades independently of the eligible entity and of any other IAC trading for the eligible entity, without knowledge of trades by any other such IAC. [9] According to the Release, the determination as to whether a trader exercises independent control over the trading decisions for customer accounts or trading programs will be decided on a case-by-case basis and will include a review of factors relevant to establishing control such as the existence of a proper firewall. Finally, instead of filing an application for exemptive relief to disaggregate, a trader will be required to file a notice and certification with the Commission, effective upon filing, justifying the decision to disaggregate.

3. Other Exemptions

The final rule includes exemptions related to commodity pools, underwriting, and information sharing. [10] Consistent with the current rules, the final rule does not require a trader who is a limited partner or shareholder in a commodity pool (other than the pool’s commodity pool operator) to aggregate as long as the trader does not control the pool’s trading decisions. Mandatory aggregation based on 25 percent ownership interest is only triggered with respect to a pool exempt from commodity pool operator registration. The final rule permits a person to disaggregate positions when ownership above the 10 percent threshold is also associated with the underwriting of securities, as well as in instances where aggregation across commonly-owned affiliates would require position information sharing that would violate federal law.

4. Process for Obtaining Disaggregation Exemption

Under existing rules, the disaggregation exemption was self-executing. Under the final rule, a trader must file (i) a notice describing the circumstances that warrant disaggregation and (ii) a certification that the trader meets the relevant conditions. Upon request by the Commission, any trader claiming a disaggregation exemption must provide relevant information concerning the claim for exemption and may be subject to audit by the Commission.

H. Position Visibility Reporting

The final rule requires periodic reports by persons holding or controlling positions, separately or in combination, net long or net short, in certain energy and metal Referenced Contracts above specified “position visibility levels.” The Commission has set the “position visibility levels” below the proposed non-spot-month position limits for the Referenced

Contracts.

I. Designated Contract Market and Swap Execution Facility Position Limits and Accountability Levels

Under the final rule, the Commission requires DCMs and swap execution facilities ("SEFs") to establish position limits for Referenced Contracts no greater than similar limits imposed by the Commission on Referenced Contracts. DCMs and SEFs have discretion to establish position accountability levels in lieu of position limits for excluded commodities and non-referenced contracts. [11] The rule provides an arbitrage exemption that traders may claim as an offset to their DCM or SEF positions.

II. The Commission's Cost-Benefit Analysis

In the Release, the Commission spends considerable time discussing the costs and benefits of the final rule and related comment letters. According to the Commission's estimates, the new rule will impose annual costs on market participants of at least $100 million, not including costs that the Commission believes are not quantifiable. Notably, the Commission states that it need not demonstrate "the existence of excessive speculation or the resulting burdens in order to take preventive action through the imposition of position limits. Similarly, the Commission need not prove that such limits will in fact prevent such burdens." Instead, the Commission repeatedly states that it is mandated by the Dodd-Frank Act to impose position limits.

III. Statement of Commissioner Scott O'Malia, Dissenting

In his dissent, Commissioner O'Malia explains that his primary disagreement is with the Commission's decision "to establish position limits without making a determination that such limits are necessary and effective, in relation to the identifiable burdens of excessive speculation on interstate commerce." According to Commissioner O'Malia, the Commission was not required by law to impose position limits without a determination that such limits are necessary and, at this time, Commissioner O'Malia asserts that the Commission lacks empirical evidence demonstrating that the final rule will diminish, eliminate, or prevent excessive speculation. Commissioner O'Malia also contends that the rule poses significant problems in the following important ways:

- by limiting the types of transactions that may qualify as bona fide hedging, the rule eliminates certain legitimate derivatives risk management strategies, including anticipatory hedging, and is not flexible enough to permit hedging strategies not yet developed or not known by the Commission;
- the aggregation framework treats owned non-financial firms, such as energy producers or merchandisers, unfairly by not providing an aggregation exemption for these firms;
- the aggregation framework does not provide an exemption where the firm owns ten percent of a subsidiary but does not control the "owned" entity's trading activities; and
- the rule does not adequately account for the possibility that significant arbitrage opportunities may arise, especially as a result of international differences in position limits and related rules.

Commissioner O’Malia further asserts that a number of the Commission’s actions and deficiencies with respect to the rule will invite legal challenge, including the Commission’s failure to evaluate whether position limits will effectively reduce excessive speculation.

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endnotes

[1] See Position Limits for Futures and Swaps, CFTC RIN 3038-AD17, available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister101811c.pdf (“Release”). See also Letters from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, Commodity Futures Trading Commission, dated March 28, 2011 and January 11, 2011, available at http://www.ici.org/pdf/11_pos_limit.pdf and http://www.ici.org/pdf/24867.pdf.

[2] The Commission voted 3 to 2 to adopt the final rule.

[3] Core Referenced Futures Contracts include: Chicago Board of Trade Corn, Oats, Soybeans, Soybean Meal, Soybean Oil, and Wheat; ICE Futures U.S. Cotton No. 2; Kansas City Board of Trade Hard Winter Wheat; Minneapolis Grain Exchange Hard Red Spring Wheat; Chicago Board of Trade Rough Rice; Chicago Mercantile Exchange Feeder Cattle, Lean Hogs, Live Cattle and Class III Milk; Commodity Exchange, Inc. Gold, Silver and Copper; ICE Futures U.S. Cocoa, Coffee C, FCOJ-A, Sugar No. 11 and Sugar No. 16; and New York Mercantile Exchange Palladium, Platinum, Light Sweet Crude Oil, New York Harbor No. 2 Heating Oil, New York Harbor Gasoline Blendstock, and Henry Hub Natural Gas. The first of nine of these are “legacy” agricultural commodities.

[4] If a trader’s pre-existing positions would cause the trader to exceed the non-spot month limits, the trader cannot increase the directional position that caused the position to exceed the limit until the trader reduces the positions to a level below the position limit.

[5] When implemented, spot-month limits will be updated annually for agricultural Referenced Contracts and biennially for energy and metal Referenced Contracts.

[6] The comment period will close 60 days after publication in the Federal Register.

[7] Non-spot-month limits will be updated and published biennially, beginning two years after publication of the initial limits.

[8] The final rule includes a “pass-through” exemption for a trader who uses Referenced Contracts to offset the risk of a swap that itself qualifies as a bona fide hedge.

[9] In the Release, the Commission explains that it will determine whether an IAC trades independently of the eligible entity and other IACs trading for the eligible entity on a case-by-case basis. The Commission will look to certain indicia of control, such as the existence of a proper firewall separating the trading functions of the IAC and the eligible entity, in determining whether a trader has control over certain positions or accounts for aggregation purposes.

[10] The final rule does not cover exchange-traded funds exposures.

[11] DCMs and SEFs also may continue to provide exemptions for “risk-reducing” and “risk management” transactions or positions in line with Commission guidelines.
