

MEMO# 29976

June 10, 2016

CFTC Issues Supplemental Notice of Proposed Rulemaking on Position Limits

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 30-16
REGISTERED FUND CPO ADVISORY COMMITTEE RE: CFTC ISSUES SUPPLEMENTAL NOTICE OF PROPOSED RULEMAKING ON POSITION LIMITS

The Commodity Futures Trading Commission (“CFTC” or “Commission”) recently issued proposed revisions and additions to the rules and guidance it proposed in 2013 regarding speculative position limits (“Supplemental Proposal”). [1] The Supplemental Proposal also would include new alternative processes for designated contract markets (“DCMs”) and swap execution facilities (“SEFs”) to recognize certain positions in commodity derivative contracts as non-enumerated bona fide hedges (“NEBFHs”) or enumerated anticipatory bona fide hedges, and to exempt certain spread positions from position limits, in each case subject to Commission review. The Supplemental Proposal would amend certain of the regulations the Commission proposed in 2013 [2] regarding exemptions from federal position limits and exchange-set position limits to take into account these proposed alternative processes. The Commission also proposes to further amend certain relevant definitions, and delay the requirement for DCMs and SEFs that lack access to sufficient swap position information to establish and monitor position limits on swaps. The Commission requests comments on the Supplemental Proposal within 30 days of its publication in the Federal Register. The Supplemental Proposal, as relevant to registered investment companies (“funds”), is summarized briefly below.

Proposed Delay in Exchange Obligations to Establish and Monitor Position Limits for Swaps

In the 2013 Proposal, the Commission proposed federal position limits on futures and swaps in physical commodities. The 2013 Proposal provided that federal position limits would apply to “referenced contracts,” [3] whether futures or swaps, regardless of where the positions are established.

The CFTC requires DCMs and SEFs that are trading facilities (collectively, “exchanges”) to establish and monitor position limits. DCM Core Principle 5 requires that DCMs must set a position limit at a level no higher than that of the federal position limit. [4] SEF Core Principle 6(B) requires that a SEF: (i) set its exchange set limit on swaps at a level no higher

than that of the federal position limit; and (ii) monitor positions established on or through the SEF for compliance with the federal position limit and any exchange-set limit. [5] Consistent with these Core Principles, the 2013 Proposal specifically provided that “[f]or any commodity derivative contract that is subject to a speculative position limit under § 150.2 . . . [a DCM or SEF] that is a trading facility shall set a speculative position limit no higher than the level specified in § 150.2.” [6]

The Commission recognizes in the Supplemental Proposal, however, that exchanges generally do not currently have access to swap position information. [7] Without such data, exchanges cannot effectively monitor swap position limits. The CFTC therefore proposes to temporarily delay for exchanges that lack access to sufficient swap position information the requirement to establish and monitor position limits on swaps.

The proposed implementation delay would apply for swaps only, and only for exchanges without sufficient swap position information. The proposed revised guidance regarding DCM Core Principle 5 and SEF Core Principle 6 would clarify that an exchange need not demonstrate compliance with these core principles, as applicable to swaps, until it has access to sufficient swap position information (after which the guidance would no longer be applicable). For clarity, the Commission also proposes to provide the same guidance in an appendix to its part 150 rules, as a new appendix E. [8]

Proposed Amendments to the Definition of Bona Fide Hedging Position

In the 2013 Proposal, the Commission proposed a new definition of “bona fide hedging position” in proposed rule 150.1, which would replace the current definition in rule 1.3(z). As in the current definition, that proposed definition would have included two requirements for a bona fide hedging position that are not included in the definition of “bona fide hedging transaction” under section 4a(c)(2) of the Commodity Exchange Act (“CEA”): an incidental test and an orderly trading requirement. The incidental test is intended to ensure that the risks offset by a commodity derivative contract hedging position must arise from commercial cash market activities. The orderly trading requirement is intended to impose on bona fide hedgers a duty of ordinary care when entering, maintaining and exiting the market in the ordinary course of business in order to avoid as practicable the potential for significant market impact in establishing, maintaining or liquidating a position in excess of position limits. These two elements have been part of the definition of bona fide hedging under rule 1.3(z) since 1975. [9]

In response to comments, the Commission proposes to eliminate the incidental test and the orderly trading requirement from the general definition of bona fide hedging definition under proposed rule 150.1. [10] The Commission believes these elements are no longer necessary. It explains that the incidental test appears to have been left in the definition as an historical carryover, and that the meaning of the orderly trading requirement is unclear and appears to be unnecessary, given other tools available to the Commission and exchanges to address disorderly or disruptive trading. [11]

Proposed Rules That Would Allow Exchanges to Recognize Certain Bona Fide Hedging Positions and Grant Spread Exemptions

The Commission has proposed three sets of rules that would enable an exchange to submit to the Commission rules that allow the exchange to take action to recognize certain bona fide hedging positions and grant certain spread exemptions. The proposed rules would apply with respect to both exchange-set and federal position limits. The proposed rules

would also establish a formal Commission review process under which, among other things, the CFTC would have the power to revoke any such exchange actions. These proposed rules would permit exchanges to: (i) recognize certain NEBFH positions, i.e., positions that are not enumerated by the Commission's rules; [12] (ii) grant exemptions to position limits for certain spread positions; [13] and (iii) recognize certain enumerated anticipatory bona fide hedging positions. [14]

Recognition of Positions as Non-Enumerated Bona Fide Hedges

The CFTC explains that DCMs have for some time set position limits on futures contracts and granted exemptions to exchange-set limits on futures contracts, including NEBFH exemptions that incorporate the Commission's general definition of bona fide hedging transactions and positions in current rule 1.3(z). [15] As discussed above, the 2013 Proposal included a definition of "bona fide hedging position" in rule 150.1 that would replace the definition in rule 1.3(z). The 2013 Proposal also would replace the process for Commission recognition of NEBFH exemptions with proposed rule 150.3(e), which would provide guidance for persons seeking relief for NEBFHs, either by Commission exemption or CFTC staff interpretation.

In light of DCM experience granting NEBFH exemptions to exchange-set position limits for futures contracts, and public comments on this aspect of the 2013 Proposal, the Commission proposes to permit exchanges to recognize NEBFHs with respect to the proposed federal speculative position limits. The proposed rules would permit exchanges to establish rules under which they could recognize as NEBFHs positions that meet the general definition of bona fide hedging position in proposed rule 150.1. If an exchange recognized a position as an NEBFH, the position would not be subject to federal position limits. The exchange's recognition would be subject to Commission review. If the Commission later determined that the exchange action was inconsistent with CEA standards, it could require a market participant that had received an NEBFH exemption to liquidate the derivative position or otherwise come into compliance with position limits within a commercially reasonable amount of time.

Process for Exemption from Position Limits for Certain Spread Positions

The Commission proposes to permit exchanges, by rule, to exempt from federal positions limits certain spread transactions, and to expand the types of spread positions for which exemptions could be granted. [16] Currently, DCMs are permitted to exempt certain spread, straddle, and arbitrage positions from their own position limits (but not from the federal position limits), or subject such positions to different DCM limits. Current rule 150.3 also provides a limited exemption from existing federal position limits for spread or arbitrage positions between single months of a futures contract (and options thereon) in the same crop year, outside of the spot month, but only when such positions combined with other net positions in the single month do not exceed the all months limits.

The Supplemental Proposal would permit the exchanges to grant spread exemptions from the federal position limits, not just the exchange limits, and proposes a process for seeking exemptions, subject to Commission review, [17] that is generally similar to the processes proposed for recognition of NEBFHs, as described above. [18] In addition, the Supplemental Proposal would expand the types of spreads for which the exchange may grant exemptions from the federal limits. First, unlike either current rule 150.3 or proposed rule 150.5(a)(2)(ii) under the 2013 Proposal, the Supplemental Proposal would not limit permitted spread exemptions to spreads outside the spot month. Second, the Supplemental Proposal would

expand the definitions of intermarket and intra-market hedges. Like the 2013 Proposal, the Supplemental Proposal would delete current rule 150.3. [\[19\]](#)

Recognition of Positions as Enumerated Anticipatory Bona Fide Hedges

In the 2013 Proposal, the Commission proposed rule 150.7, which set out requirements for seeking anticipatory bona fide hedging position exemptions, and would replace the current process for classifying certain anticipatory bona fide hedge positions under rule 1.3(z). Proposed rule 150.7 would have required market participants to file statements with the Commission regarding certain anticipatory hedges, which would become effective absent Commission action or inquiry ten days after submission. The Commission proposes to supplement this process by allowing, as an alternative, exchanges to review requests for recognition of enumerated anticipatory bona fide hedging exemptions pursuant to rules submitted to the Commission. The Commission explains that this proposed process would supplement the enumerated anticipatory bona fide hedging positions that it expects to include in the final position limits rules. [\[20\]](#) Exemptions issued by the exchanges would be subject to Commission review, similar to the process described above for recognition of NEBFHs.

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endnotes

[\[1\]](#) Position Limits for Derivatives: Certain Exemptions and Guidance, available at <http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/federalregister052616.pdf> (“Proposing Release”).

[\[2\]](#) See Position Limits for Derivatives, 78 Fed. Reg. 75680 (Dec. 12, 2013), available at <http://www.cftc.gov/idc/groups/public/@lfederalregister/documents/file/2013-27200a.pdf> (“2013 Proposal”). For a summary of the 2013 Proposal, please see ICI Memorandum No. 27707 (Nov. 19, 2013), available at https://www.ici.org/my_ici/memorandum/memo27707.

[\[3\]](#) Under the 2013 Proposal, “referenced contracts” would include futures, options, economically equivalent swaps, and certain board of trade contracts, in physical commodities.

[\[4\]](#) CFTC rule 38.300.

[\[5\]](#) CFTC rule 37.600.

[\[6\]](#) See proposed rule 150.5(a)(1).

[\[7\]](#) The CFTC explains that, while futures contracts are proprietary to a particular DCM and are typically cleared at a single derivatives clearing organization (“DCO”) affiliated with the DCM, swaps in a particular commodity are not proprietary to any particular trading facility or platform. It further notes that, under CFTC rules, swap data may be reported to any swap data repository (“SDR”). Swaps on physical commodities also are not subject to mandatory clearing or trading.

[\[8\]](#) The Commission’s proposed guidance therefore would appear both in Parts 37 and 38,

which address SEFs and DCMs, respectively, and include the Core Principles, and in Part 150, which comprises the position limits rules.

[9] Proposing Release, *supra* note 1, at 20.

[10] The Commission notes that the proposed definition “is subject to further requirements not inconsistent with [the statutory standards of section 4a(c) of the CEA] and the policy objectives of position limits.” Proposing Release, *supra* note 1, at 19.

[11] *Id.* at 21-22.

[12] Proposed rule 150.9.

[13] Proposed rule 150.10.

[14] Proposed rule 150.11. The Commission also proposes conforming changes to rule 150.3, which establishes exemptions from federal position limits; rule 150.5(a)(2), which provides guidance to DCMs for exchange-set position limits; and proposed rule 150.5(b) (part of the 2013 Proposal), which would establish requirements and acceptable practices for commodity derivative contracts not subject to federal position limits.

[15] Proposing Release, *supra* note 1, at 35.

[16] The Commission states that this would not include spread exemptions for a swap position that was executed opposite a counterparty for which the transaction would not qualify as a bona fide hedging transaction.

[17] Proposed rule 150.10(a)(1).

[18] Proposed rule 150.9.

[19] The 2013 Proposal would eliminate the difference between single month and all month combined limits, and would effectively nullify the effect of the rule 150.3 exemption for single month positions capped at the all month limit. The Commission therefore proposed in the 2013 Proposal to delete that exemption. The 2013 Proposal also would codify, in proposed rule 150.5(a)(2), guidance allowing an exchange to grant exemptions from exchange limits for intra-market and intermarket spread positions (as defined in the 2013 Proposal), for contracts subject to federal limits. As proposed in 2013, both inter- and intra-market spread positions would have to be outside of the spot month for physical delivery contracts, and intra-market spread positions could not exceed the federal all months combined limit when combined with other net positions in the single month.

[20] See Proposing Release, *supra* note 1, at 85.