**CFTC Proposes Speculative Position Limits – Again**

On November 5, 2013, the Commodity Futures Trading Commission (“CFTC” or “Commission”) proposed new speculative position limits. The proposal (“New Proposal”) would establish spot-month and non-spot-month limits for 28 core physical commodity contracts and their “economically equivalent” futures, options, and swaps (collectively, “referenced contracts”). The CFTC had finalized position limits in a 2011 rulemaking (“2011 Rule”), but a federal court vacated the 2011 Rule. The New Proposal constitutes the Commission’s latest effort under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) to establish federal position limits for specified physical commodity contracts beyond those already in place for certain agricultural contracts. The New Proposal would institute a position limits regime largely identical to that prescribed by the 2011 Rule, with some exceptions. The Commission approved the New Proposal for publication in the Federal Register by a 3 to 1 vote, with Commissioner Scott O’Malia casting the lone dissenting vote. The Commission also unanimously approved an accompanying proposal (“Aggregation Proposal”) that would expand the exemptions from aggregating positions that had been available under the 2011 Rule and a subsequent May 2012 proposal.

This client alert summarizes the New Proposal and the Aggregation Proposal and highlights key similarities and differences between these proposals and the 2011 Rule. The New Proposal will be open to public comment for 60 days after it is published in the Federal Register, which has not yet occurred. The Aggregation Proposal will be open to comment until January 14.

**BACKGROUND FOR THE NEW PROPOSAL**

The New Proposal marks the second time in as many years that the Commission has sought to establish a new, expanded position limits regime under Dodd-Frank beyond that currently in effect for certain “legacy” agricultural futures and options. Title VII of Dodd-Frank amended Section 4a of the Commodity Exchange Act (“CEA”) to give the CFTC authority to establish position limits to curb and prevent “excessive speculation” in commodities markets. In November 2011, acting pursuant to its perceived authority, the Commission issued the 2011 Rule, which established spot-month and non-spot-month position limits for 28 referenced contracts. However, in September 2012, shortly before certain of the new limits were to go into effect, a federal district court invalidated the 2011 Rule in a lawsuit brought by industry representatives.¹ Whereas the CFTC had argued that Section 4a unambiguously required it to establish position limits, the court held that the CEA was at least ambiguous on this point, and that another plausible interpretation was that the statute required the CFTC to find position limits necessary before imposing them. The court remanded the 2011 Rule to the CFTC to resolve the ambiguity.

Responding to the court’s directive, the CFTC in the New Proposal clarifies that it believes Section 4a mandates the imposition of position limits. The CFTC goes on to say that even if this were not so, and it had discretion to impose position limits, such limits would be necessary to achieve Dodd-Frank’s purposes based on its experience

---

regulating commodities markets. In support of this “necessity finding,” the Commission cites to the attempted cornering of the silver market by the Hunt brothers in 1979-80, and the 2006 collapse of the Amaranth Advisors hedge fund through natural gas trading on the NYMEX, and states its belief that had the position limits provided for in the New Proposal been in place at those times, they would have prevented the accumulation of large positions and resulting market disruption in both episodes. Commissioner O'Malia criticizes the Commission's reliance on these historic examples in his dissent, stating that it should have analyzed the new swaps data collected under Dodd-Frank while recognizing that such data is still unreliable. The Commission also reviewed 132 studies analyzing the impact of position limits or the role of speculation on commodity prices. While recognizing a lack of consensus in the studies, the CFTC states that such lack of consensus warrants erring on the side of caution and imposing position limits as a prophylactic measure.

CONTRACTS SUBJECT TO PROPOSED POSITION LIMITS

Like the 2011 Rule, the New Proposal establishes position limits for 28 referenced contracts. The specified commodity contracts span the energy, metal, and agricultural commodities markets, as set forth below.

- **Four energy contracts**: (1) NYMEX Henry Hub Natural Gas (NG), (2) NYMEX Light Sweet Crude Oil (CL), (3) NYMEX RBOB Gasoline (RB), and (4) NYMEX NY Harbor ULSD (HO).
- **Five metal contracts**: (1) COMEX Copper (HG), (2) COMEX Gold (GC), (3) COMEX Silver (SI), NYMEX Palladium (PA), and (5) NYMEX Platinum (PL).
- **Nine “legacy” agricultural contracts**: (1) CBOT Corn (C), (2) CBOT Oats (O), (3) CBOT Soybeans (S), (4) CBOT Soybean Meal (SM), (5) CBOT Soybean Oil (BO), (6) CBOT Wheat (W), (7) ICE Futures U.S. Cotton No.2 (CT), (8) KCBT Hard Winter Wheat (KW), and (9) MGEX Hard Red Spring Wheat (MWE).
- **Ten non-“legacy” agricultural contracts**: (1) CME Class III Milk (DA), (2) CME Feeder Cattle (FC), (3) CME Lean Hog (LH), (4) CME Live Cattle (LC), (5) CBOT Rough Rice (RR), (6) ICE Futures U.S. Cocoa (CC), (7) ICE Futures U.S. Coffee C (KC), (8) ICE Futures U.S. FCOJ-A(OJ), (9) ICE Futures U.S. Sugar No. 11 (SB), and (10) ICE Futures U.S. Sugar No. 16 (SF).

The CFTC said it would consider expanding the list of referenced contracts, including with regard to electricity and other energy commodities, as appropriate in subsequent rulemakings.

Economically equivalent contracts subject to the federal limits would include contracts directly or indirectly linked or priced at a fixed differential to the price of one of the core referenced contracts specified above or the price of the same commodity with the same delivery location or locations as one of the core referenced contracts.

A key similarity between the New Proposal and the 2011 Rule is that basis contracts and commodity index contracts would not be subject to the federal position limits. Also, whereas the 2011 Rule defined basis contracts to target locational price differentials, the New Proposal would expand the definition to include contracts cash-settled on the difference in price of two different, but economically closely related, commodities, and includes an appendix that contains commodities that would be substantially the same for purposes of the basis contract definition.
PROPOSED POSITION LIMITS

The New Proposal would establish both spot-month and non-spot-month federal position limits for the referenced contracts. Spot-month limits would apply in the period immediately before delivery obligations are incurred for physical-delivery contracts or a period immediately before contracts are liquidated by the clearinghouse based on a reference price for cash-settled contracts. The spot-month period would not necessarily correspond to a month-long period and would extend through the period when the contract is no longer listed for trading or available for transfer. Non-spot-month limits, on the other hand, would apply to positions in all contract months combined or in a single contract month. Mirroring the 2011 Rule, the limits would apply across CFTC-regulated exchanges.

Both the spot-month and non-spot-month limits would go into effect 60 days after publication of a final position limits rule in the Federal Register.

Spot-Month Limits

The CFTC proposes to set spot-month limits at levels currently in place at designated contract markets ("DCMs"). Subsequent levels would be adjusted at least every two years and be based on the Commission’s determination of the estimated deliverable supply (developed in consultation with DCMs) in the relevant contract. These levels would be set at 25 percent of the deliverable supply estimates. Spot-month positions in physical-delivery referenced contracts and cash-settled referenced contracts would be calculated separately, meaning that a trader would be able to hold positions up to the spot-month limit in physical-delivery contracts, as well as positions up to the applicable spot-month limit in cash-settled contracts in the same commodity. However, a trader in the spot month would not be able to net across physical-delivery and cash-settled contracts.

The New Proposal would provide a conditional spot-month limit exemption that permits a trader to acquire positions up to five times the spot-month limit if such positions are exclusively in cash-settled contracts and the trader does not hold any position in physical-delivery contracts for the relevant commodity. By contrast, the 2011 Rule had only provided such an exemption for cash-settled natural gas referenced contracts.

In the New Proposal, the Commission seeks comment on whether it should adopt higher spot-month limits based on estimates of deliverable supply submitted by the CME Group in July 2013. For the energy referenced contracts, the alternative spot-month limits would be a minimum of nearly four times those proposed in the first instance by the Commission. Under a further alternative, the Commission is requesting comment on whether it should adopt initial spot-month limits, in its discretion, based on a level recommended by each DCM listing the referenced contract, 25 percent of the estimated deliverable supply or the current exchange limits. The Commission also seeks comment on the conditional spot-month limit exemption for cash-settled referenced contracts, including whether the ban on holding physical-delivery contracts in the relevant commodity should be a condition of the relief, whether to restrict the trader claiming the exemption to positions in cash-settled contracts that settle to an index based on cash-market transactions, whether the conditional exemption should be expanded to all contracts as proposed, and whether the exemption should be adopted at all.
Non-Spot-Month Limits

As in the 2011 Rule, the CFTC proposed to set initial non-spot-month limits based on total open interest for all referenced contracts in a commodity. The actual limit would be set using the 10/2.5 percent formula: 10 percent of the contract’s first 25,000 of open interest and 2.5 percent thereafter. Subsequent levels would be adjusted at least every two years based on referenced contract open interest for a calendar year.

EXEMPTIONS FROM PROPOSED POSITION LIMITS

Like the 2011 Rule, the New Proposal would exempt certain positions from the federal position limits.

Bona Fide Hedging Positions

Perhaps the most controversial feature of the 2011 Rule was that it narrowed the bona fide hedging exemption contained in CFTC Regulation § 1.3(z), which is generally available for physical commodity price risk-reducing transactions, to a list of eight “enumerated” bona fide hedging transactions. The New Proposal would again limit bona fide hedging exemptions to certain enumerated transactions, with some modifications. Commissioner O'Malia criticizes this approach in his dissenting statement, stating that “I question whether the Commission has fulfilled Congress’ intent to protect end-users by proposing a new position limits rule that articulates a far too narrow conception of bona fide hedging and does not reflect the realities of end-users’ commercial and business operations.”

Reiteration of Enumerated Hedges

The New Proposal would establish the following bona fide hedging exemptions in materially the same form that they had been provided for in the 2011 Rule:

- Inventory and fixed-price cash commodity purchase contracts.
- Fixed-price cash commodity contracts.
- Unfilled anticipated requirements for same cash commodity.
- Hedges by agents.
- Unsold anticipated production.
- Services.
- Pass-through swaps and offsets.

Expansion of Enumerated Hedges

The New Proposal would also provide expanded bona fide hedging exemptions compared to the 2011 Rule for (1) transactions that offset unfixed-price cash commodity sales and purchases and (2) cross-commodity hedges. The CFTC would expand the exemption for transactions that offset unfixed-price cash commodity sales and purchases to include unfixed-price cash contracts basis different commodity contracts in the same commodity,
regardless of whether the commodity contracts are in the same calendar month. The CFTC would expand the cross-commodity hedging exemption to apply not only to all enumerated hedging exemptions, but also to pass-through swaps. Despite the proposed expansion of the cross-commodity hedging exemption, the Commission cautions energy market participants that it typically would not view electricity contracts as being sufficiently related to fluctuations in the price of natural gas to qualify for the cross-commodity hedging exemption. However, the Commission clarifies that an electric generator that owns or leases a natural gas generator may qualify for an unfilled anticipated requirements hedging exemption to meet a fixed-price power commitment in the form of an electricity sale.

Of note to utilities, the New Proposal would establish an enumerated hedging exemption for a utility’s unfilled anticipated requirements of customers that was not provided for in the 2011 Rule. This exemption would be analogous to the enumerated unfilled anticipated requirements hedging exemption, except the commodity would not have to be for use by the same person (i.e., the utility) but instead could be for use by the utility’s customers. The proposed new exemption would recognize a bona fide hedging position where a utility is required or encouraged to hedge by its state public utility commission (“PUC”). As justification for the new exemption, the Commission cites natural gas utilities’ need — and sometimes obligation under PUC rules — to reduce risks associated with anticipated natural gas requirements in order to serve retail customers.

*Restriction of Enumerated Hedges*

But, just as the New Proposal would giveth, it also would taketh away. Although the New Proposal would include a bona fide hedging exemption for anticipated royalties, the exemption would be narrower than that provided for in the 2011 Rule. Under the vacated 2011 Rule, the exemption encompassed sales or purchases in commodity contracts offset by the anticipated change in value of royalty rights that were owned by the same person and that arose out of the production, manufacturing, processing, use or transportation of the commodity underlying the commodity contract, subject to certain additional conditions. By contrast, the exemption would only be available under the New Proposal for sales (i.e., short positions) in commodity contracts offset by the anticipated change in value of mineral royalty rights that are owned by the same person and that arise out of the production of a mineral commodity (e.g., oil or natural gas). In support of the narrower proposal, the Commission preliminarily concluded that manufacturing, processing, using or transporting a commodity does not relate to royalties. The New Proposal solicits comment on the modified royalties hedging exemption proposal.

And, in a further departure from the 2011 Rule, the New Proposal would not include a bona fide hedging exemption for unfilled storage capacity as anticipated merchandising. The 2011 Rule permitted a person to claim an exemption for offsetting sales and purchases of commodity contracts that did not exceed in quantity the amount of the same cash commodity that was anticipated to be merchandised. The Commission now doubts such transactions could be economically appropriate to the reduction of commercial risks when, based on its experience, the value fluctuations in a calendar month spread in a commodity contract have at best a low correlation with value fluctuations in expected returns on unfilled storage capacity. The Commission is seeking comment on this issue.
Examples of Enumerated Hedges

An appendix to the New Proposal includes examples of transactions meeting the enumerated bona fide hedges. Tracking the 2011 Rule, the New Proposal invites persons engaged in other types of risk-reducing transactions to apply for relief from the federal limits by either (1) requesting an interpretive letter from Commission staff pursuant to CFTC Regulation § 140.99 regarding the applicability of a hedging exemption or (2) seeking exemptive relief from the Commission under CEA Section 4a(a)(7).

Financial Distress Exemption

The New Proposal includes a provision similar to the 2011 Rule pursuant to which, upon request, the CFTC may exempt a person or related persons under financial distress circumstances from the federal position limits. Financial distress circumstances include situations involving the potential default or bankruptcy of a customer of the requesting person, an affiliate of the requesting person, or a potential acquisition target of the requesting person. Unlike the 2011 Rule, the provision does not require that the Commission grant such an exemption by order, which may enhance the Commission's flexibility in financial distress situations.

Pre-Enactment and Transition Swaps

The New Proposal would generally exempt (1) swaps entered into before July 21, 2010 (the date of enactment of Dodd-Frank) that have not expired as of that date (“pre-enactment swaps”) and (2) swaps entered into during the period commencing July 22, 2010 that have not expired as of that date and ending 60 days after publication of a final position limits rule in the Federal Register (“transition swaps”). However, the Commission would permit pre-enactment swaps and transition swaps to be netted with commodity contracts acquired more than 60 days after publication of a final position limits rule for purposes of complying with any non-spot-month limit.

Pre-Existing Non-Spot-Month Positions

In addition to exempting pre-enactment swaps and transition swaps, the New Proposal would make any other position acquired by a trader in good faith before the effective date of such limit exempt from non-spot-month limits. However, the pre-existing position would be attributed to the trader if the trader increased the position after the effective date of such limit. Thus, a trader’s pre-existing position alone would not cause the trader to violate a non-spot-month limit, but the trader could not increase the directional position that caused the position to exceed the limit until the trader reduced the position to below the limit. Notwithstanding the above, pre-existing limits would remain subject to spot-month limits.

Recordkeeping and Reporting

The New Proposal would generally require persons claiming an exemption from the federal limits to maintain complete books and records concerning their related cash, forward, futures, options and swap positions. Such persons would also have to furnish their books and records to the Commission upon request.

Persons claiming an exemption from the limits would also generally have to make certain reports to the Commission. For example, bona fide hedgers would need to file a Form 204 on a monthly basis reflecting their cash market positions as of the last Friday on the month. Persons claiming a conditional spot-month limit
exemption would need to file a new Form 504 daily for commodity contracts specified by the Commission – initially only natural gas contracts. Persons relying on the pass-through swap and offset exemptions would need to file a new Form 604. Finally, persons claiming anticipatory hedging exemptions would be required to file a new Form 704 describing the anticipated activity at least 10 days in advance of entering into positions that would exceed a limit. Persons that have submitted a Form 704 would also have to provide annual updates detailing their actual cash market activities related to the anticipated exemption. The New Proposal includes samples of the new forms and seeks comment on them.

TRADE OPTIONS

Of potential interest to commercial market participants, the Commission is seeking comment on whether trade options should be exempted from the federal limits. Although trade options are subject to a more limited set of Dodd-Frank requirements than other swaps, they currently are subject to position limits under the CFTC regulation providing for the trade option exemption, and will remain so unless exempted.

PROPOSED AGGREGATION EXEMPTIONS

In addition to the New Proposal, the CFTC unanimously approved the Aggregation Proposal that would expand the exemptions from aggregating positions that had been available under the 2011 Rule. Consistent with Commission precedent, the 2011 Rule had generally required a person to aggregate positions or accounts in which the person directly or indirectly controlled trading or held a 10% or greater ownership interest. A subsequent proposal in May 2012 concerning aggregation standards – which effectively was mooted by the invalidation of the 2011 Rule that it proposed to amend – would have relaxed that requirement and provided certain other aggregation exemptions. The Aggregation Proposal would establish aggregation rules substantially similar to those proposed in May, with some modifications that would further expand the scope of exemptions available to market participants.

Notably, the Aggregation Proposal would amend the Commission’s current aggregation standards and permit additional exemptions from aggregation where:

- **Sharing positional information would violate or create a reasonable risk of violating federal, state or foreign law.** The Commission had proposed in May to make this exemption contingent on submission of a notice, effective upon filing, and written opinion of counsel describing the violation. The Aggregation Proposal would relax the second requirement by allowing a person to file a written memorandum of law, which would not have to be prepared by outside counsel.

- **Ownership interest is up to 50 percent in an entity whose trading is independently controlled.** The Aggregation Proposal would establish this exemption on terms nearly identical to those proposed in May. Persons would have to submit a notice, effective upon filing, demonstrating the independence of the owned entity’s trading operations with regard to certain criteria.

- **Ownership interest is greater than 50 percent in a non-consolidated entity whose trading is independently controlled and an applicant certifies that such entity’s positions either qualify as bona fide hedging positions or do not exceed 20 percent of any position limit.** This exemption would expand the exemptions
Client Alert

proposed in May by permitting a person with more than 50 percent ownership of an owned entity to apply to the Commission for relief from aggregation on a case-by-case basis. The person would have to satisfy certain conditions, including that the person’s positions qualify as bona fide hedges or do not exceed 20 percent of a position limit. In contrast to the other proposed exemptions, this relief would not be effective upon application and instead would be available only if and when the Commission grants a request for relief. If a person could not meet the conditions of this relief, the person could apply for relief from aggregation under CEA Section 4a(a)(7).

- Ownership results from broker-dealer activities in the normal course of business as a dealer. Like the Commission’s proposal in May, the Aggregation Proposal would provide an exemption from aggregation for an ownership interest of a broker-dealer registered with the Securities and Exchange Commission, or similarly registered with a foreign regulatory authority, in an entity based on the ownership of securities acquired as part of reasonable activity in the normal course of business as a dealer. However, mirroring the May proposal, the Aggregation Proposal would not make the exemption available where a broker-dealer acquires more than a 50 percent ownership interest in another entity.

The New Proposal has not yet been published in the Federal Register but is available on the CFTC’s website here. The Aggregation Proposal was published in the Federal Register on November 15 and is available here.

Contact:

Michael Sorrell  
(202) 887-8795  
msorrell@mofo.com

Julian Hammar  
(202) 887-1679  
jhammar@mofo.com

David Kaufman  
(212) 468-8237  
dkaufman@mofo.com

Daniel Nathan  
(202) 887-1687  
dnathan@mofo.com

Robert Fleishman  
(202) 887-8768  
rfleishman@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We’ve been included on The American Lawyer’s A-List for 10 straight years, and Fortune named us one of the “100 Best Companies to Work For.” Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.