haynesboone
Setting precedent.

Derivatives Alert

November 16, 2011

Update on CFTC Rulemaking:
CFTC Issues Final Rules on Position Limits for Commodity Futures and Swaps

At its open meeting on October 18, 2011, the Commodity Futures Trading Commission ("**CFTC**") adopted final rules (the "**Position Limit Rules**") to establish speculative position limits for 28 physical commodity futures and options contracts ("**Core Referenced Futures Contracts**") and futures, options, swap, or swaption contracts that are economically equivalent to such Core Referenced Futures Contracts (together with the Core Referenced Futures Contracts, collectively, "**Referenced Contracts**"). The position limits will restrict the net long or short positions that traders may hold or control in Referenced Contracts in a particular commodity, subject to exemptions for certain pre-existing positions and positions falling within a bona fide hedging exemption.

The Position Limit Rules were issued pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") and will take effect 60 days following publication in the Federal Register. Publication is expected to occur in the coming days; in the meantime, a prepublication copy is currently available on the CFTC's website.

Traders will not be required to comply with the position limits: (a) until 60 days after the CFTC and the Securities and Exchange Commission ("**SEC**") have issued rules finalizing the definition of the term "swap" and (b) in the case of non-spot month position limits on certain "non-legacy" Referenced Contracts, until after the CFTC has also received one year of open interest data to enable it to determine the appropriate limits.

Spot Month and Non-Spot Month Position Limits

Position limits for Referenced Contracts will be established separately for *spot months* (periods immediately before delivery, in the case of physical-delivery contracts, or before liquidation by the relevant clearinghouse based on a reference price, in the case of cash-settled contracts) and *non-spot months* (all other periods). Spot month periods are specified for each Referenced Contract and do not necessarily coincide exactly with calendar months.

Spot Month Position Limits

Spot month position limits will restrict the net long or short positions that traders may hold or control in Referenced Contracts in a particular commodity during the applicable spot month. As indicated above, spot month position limits will become effective for all Referenced Contracts 60 days after the CFTC and the SEC jointly issue final rules defining the term "swap" for purposes of the Dodd-Frank Act. In September 2011, the CFTC released a proposed rulemaking timeline indicating that it would consider final rules during the final quarter of 2011, while the SEC has not given specific indications on its timing.[1] However, in light of its recent postponements of public meetings, it is possible that the CFTC and the SEC may not finalize these rules until 2012.

[1] Please see "Derivatives Alert: Update on CFTC Dodd-Frank Rulemaking: CFTC Outlines Rulemaking and Implementation Timelines and Announces Delays in Large Trader Reporting Requirements," Oct. 17, 2011, available at http://www.haynesboone.com/update_on_cftc_dodd-frank_rulemaking/. The joint proposed rules defining "swap," "security-based swap," and other key terms that were issued on May 23, 2011 by the CFTC and the SEC are available on the CFTC's website.

Spot month position limits will generally be set at 25 percent of the estimated spot month deliverable supply for the relevant commodity for each Referenced Contract (other than cash-settled NYMEX Henry Hub Natural Gas contracts, which will be subject to a separate set of position limits described below).

The initial spot month position limits for each Referenced Contract are specified in an appendix[2] to the Position Limit Rules and have been determined based on the spot month position limits currently imposed by the designated contract markets on which the related Core Referenced Futures Contracts are traded. After the first year, spot month position limits will be subject to adjustment on an annual or biannual basis[3] (with such adjustments to be made based on information regarding deliverable supply to be provided by the relevant designated contract markets).

Conditional Spot Month Limits for NYMEX Henry Hub Natural Gas Contracts Only

Spot month position limits for Referenced Contracts will generally be calculated and applied separately for physically-delivered and cash-settled Referenced Contracts in the same commodity. Thus, in determining net position in a particular commodity for purposes of the spot month position limits, a trader may not net its positions in physical-delivery Referenced Contracts against its positions in cash-settled Referenced Contracts (except in the case of NYMEX Henry Hub Natural Gas contracts).

This reflects a change from the CFTC's proposed rules issued on January 26, 2011 (the "**Proposed Rules**"), which had provided for "conditional spot month limits" that would have permitted a trader to hold positions in cash-settled Referenced Contracts of up to five times the spot month position limit; provided that it held (i) no positions in physical-delivery Referenced Contracts in the relevant commodity and (ii) less than 25 percent of the estimated deliverable supply of such commodity. The proposed conditional spot month limits were opposed by some futures market participants who argued that it could distort the market and encourage regulatory arbitrage by driving trading volume to the cash-settled market, while reducing liquidity in the physically-delivered market.[4]

NYMEX Henry Hub Natural Gas contracts, in contrast to other Referenced Contracts, will be subject to a set of conditional spot month limits similar to those provided in the Proposed Rules, but slightly modified, which will permit a larger position in cash-settled contracts under certain circumstances:

(i) a "class limit" spot month position limit for physical-delivery contracts of 25 percent of estimated spot month deliverable supply;
(ii) a "class limit" spot month position limit for cash-settled contracts of five times the normal spot month position limit (i.e., five times 25 percent of estimated spot month deliverable supply); and

[2] See Appendix A to the prepublication version of the Position Limit Rules.
[3] Note that the CFTC's fact sheet regarding the Position Limit Rules and comments made by CFTC staff member Steven Sherrod during the October 18, 2011 meeting (as reflected in the meeting transcript) both state that the adjustments will be made biannually for agricultural contracts and annually for energy and metals contracts, while the text of §151.4(d)(2) set forth in the prepublication version of the Position Limit Rules provides that the adjustments will be made biannually for energy and metals contracts and annually for agricultural contracts. The Proposed Rules, meanwhile, had called for annual adjustment of all spot month position limits.
[4] See Commodity Markets Oversight Coalition Comment Letter on Position Limits for Derivatives, dated Aug. 31, 2011, available at: http://comments.cftc.gov/PublicComments/CommentList.aspx?id=965; Silla Brush, "CFTC May Alter Dodd-Frank Speculative Trading Limit CME Opposed," *Bloomberg,* Sept. 22, 2011, available at: http://www.bloomberg.com/news/2011-09-22/cftc-may-alter-dodd-frank-speculative-trading-limit-cme-opposed.html; Gregory Meyer, "CME Takes Aim at 'Parasitic Derivatives,'" *Financial Times,* Sept. 9, 2011, available at: http://www.ft.com/intl/cms/s/0/c84bf896-da27-11e0-90b2-00144feabdc0.html.

(iii) an "aggregate limit" spot month position limit (across positions in both physical-delivery and cash-settled contracts) of five times the normal spot month position limit (i.e., the same five times 25 percent of estimated spot month deliverable supply).

For example, if the class limit for physical-delivery contracts permits a trader to hold a long position of 100 physical-delivery contracts, then the trader could also hold cash-settled contracts up to either (i) a long position of up to 400 contracts (which would leave it with an aggregate net long position equal to the aggregate limit of 500 contracts), or (ii) a short position of up to 500 contracts (leaving it with an aggregate net short position equal to 400 contracts – the aggregate limit itself would permit a short position of up to 600 contracts, but the class limit for cash-settled contracts would still limit the trader's short position in cash-settled contracts to only 500 contracts). A trader could also hold no position in physical-delivery contracts and devote its entire position to cash-settled contracts up to the aggregate limit of 500 contracts.

In its release accompanying the prepublication version of the Position Limit Rules (the "**Release**"), the CFTC expressed a general preference for parity between position limits on physical-delivery and cash-settled Referenced Contracts, in part to avoid encouraging price discovery and liquidity to migrate to the type of contracts subject to higher position limits. But the CFTC also indicated its belief that the cash-settled market in natural gas is sufficiently different from the cash-settled market in other physical commodities to justify the higher conditional spot month limits for NYMEX Henry Hub Natural Gas contracts. In any case, the CFTC noted that the initial spot month position limits were being adopted on an "interim final rule basis" and that they are subject to adjustment after the first year following effectiveness.

Non-Spot Month Position Limits

Non-spot month position limits will restrict the net long or short positions that traders may hold or control in Referenced Contracts in a particular commodity, in all months combined (including the spot month) or in any single month.

Non-spot month position limits will become effective:

- for Referenced Contracts on "legacy" agricultural commodities (for which position limits are currently imposed under Part 150 of the CFTC's regulations; these are listed below under "Referenced Contracts"), 60 days after the CFTC and the SEC jointly issue final rules defining the term "swap" for purposes of the Dodd-Frank Act; and
- for Referenced Contracts on energy and metal commodities and "non-legacy" agricultural commodities (listed below under "Referenced Contracts"), within one month after the CFTC has received one year of open interest data following effectiveness of the Position Limit Rules.[5]

Non-spot month position limits for each Referenced Contract will be set initially at 10 percent of the estimated all-months-combined open interest in the first 25,000 contracts, and 2.5 percent for additional contracts thereafter. Non-spot month position limits will be subject to adjustment on a biannual basis based on open interest data regarding futures, options, and cleared and uncleared swaps.

[5] In the Release, the CFTC noted that it would need more time to formulate position limits for these Referenced Contracts because open interest data on the relevant contracts is not currently available.

A trader's positions in cash-settled and physical-delivery Referenced Contracts will be aggregated for purposes of the non-spot month position limits to determine such trader's aggregate single-month and all-months-combined position in the relevant Referenced Contracts (unlike in the case of the spot month position limits, which are applied separately for cash-settled and physical-delivery contracts).

Referenced Contracts

The Position Limit Rules apply position limits for (i) 28 physical commodity futures and options comprising the Core Referenced Futures Contracts, and (ii) futures, options, swap, or swaption contracts that are economically equivalent to such Core Referenced Futures Contracts which, together with the Core Referenced Futures Contracts, comprise the Referenced Contracts.

Core Referenced Futures Contracts

The Core Referenced Futures Contracts include the following contracts, including nine "legacy" agricultural contracts which are currently subject to position limits, ten "non-legacy" agricultural contracts, four energy contracts, and five metal contracts:

- *legacy agricultural commodity 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);
- *non-legacy agricultural commodity 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);
- *energy contracts*: (1) NYMEX Henry Hub Natural Gas (NG); (2) NYMEX Light Sweet Crude Oil (CL); (3) NYMEX New York Harbor Gasoline Blendstock (RB); and (4) NYMEX New York Harbor Heating Oil (HO); and
- *metal contracts*: (1) COMEX Copper (HG); (2) COMEX Gold (GC); (3) COMEX Silver (SI); (4) NYMEX Palladium (PA); and (5) NYMEX Platinum (PL).

Economically Equivalent Contracts

For purposes of the Position Limit Rules, a futures, options, swap, or swaption contract is deemed to be economically equivalent to a particular Core Referenced Futures Contract when it is:

- a *"look-alike" contract* that settles off of the Core Referenced Futures Contract or a contract based on the same commodity for the same delivery location as such Core Referenced Futures Contract;
- a contract with a reference 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,[6] or
- an *intercommodity spread contract* with two components, one or both of which are Referenced Contracts.

[6] In the Release, the CFTC gives the example of a swap with a floating price based on the average of the settlement price of the NYMEX Light, Sweet Crude Oil futures contract and the settlement price of the ICE Brent Crude futures contract.

In the Release, the CFTC listed some examples to clarify whether certain types of swaps would constitute Reference Contracts due to their economic equivalence to Core Referenced Futures Contracts.

For example, a swap that is priced at a "*fixed differential*" to a Core Referenced Futures Contract (for example, a swap with the commodity reference price "NYMEX Light, Sweet Crude OIL +$3 per barrel") would be a Referenced Contract. A swap based on the difference in price of the same or substantially the same commodity at different delivery locations (a "*basis contract*"), or a swap based on prices of multiple different commodities comprising an index (a "*commodity index contract*"), however, would not be a Referenced Contract. Nor would a swap based on the same commodity and having substantially the same supply and demand fundamentals as a Core Referenced Futures Contract (as this would require individualized evaluation of trading data not readily available to the CFTC).

On the other hand, a swap based on the difference between the prices of two different commodities, with one linked to a Core Referenced Futures Contract price and the other either not linked to the price of a Core Referenced Futures Contract or linked to the price of a different Core Referenced Futures Contract, would be an "*intercommodity spread contract*" and would, therefore, be a Referenced Contract.

Bona Fide Hedging Exemption

The Position Limit Rules exclude bona fide hedging transactions from the position limit calculations. To qualify, such a transaction must be among a list of enumerated types and must also:

(i) represent a substitute for transactions made or to be made or position taken or to be taken at a later time in a physical marketing channel;

(ii) be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise;

(iii) arise from the potential change in the value of assets, liabilities, or services involved with a person;

(iv) if it is hedging a swap, reduce the risks of a swap that otherwise qualifies as a bona fide hedging transaction; and

(v) comply with other referenced provisions dealing with establishing and liquidating hedges, enumerated hedge transactions, and pass-through swaps and offsets.

In response to comment letters received from the public, the CFTC expanded the scope of the enumerated exemptions beyond that contained in the Proposed Rules, such that it now includes anticipated merchandising transactions (for example, an energy company's sale of heating oil futures to hedge its anticipated exposure with respect to a planned purchase and resale of heating oil), royalties, and service contracts.[7] Commissioner Scott O'Malia, however, pointed out in his statement of dissent that the Position Limit Rules effectively narrow the scope of the bona fide hedging exemption from that currently in place with respect to legacy agricultural contracts.[8]

---

[7] See Brian Scheid, "US CFTC Plans to Expand Exemptions from Position Limits Regime," *Platt's,* Sept. 22, 2011, available at: http://www.platts.com/RSSFeedDetailedNews/RSSFeed/Oil/6513276.

[8] Currently, Part 1.3(z) of the CFTC's Regulations provides for an exemption for transactions or positions that "normally" (rather than "actually") represent a substitute for a physical market transaction.

The final Position Limit Rules contain a mechanism for traders to petition the CFTC for exemptive relief for risk-reducing hedging practices commonly used in the market that they believe are not specifically enumerated exemptions. Both Commissioner O'Malia and Commissioner Jill Sommers pointed out, however, that this provided less flexibility than the current system in which the CFTC is empowered to recognize non-enumerated hedging transactions or positions as bona fide hedges upon request, as interpretive relief is likely to result in delay and provide less certainty, while any amendments to the list of enumerated transactions or positions would require further rulemaking. As such, Commissioner O'Malia observed, these changes could limit the ability of commercial operators to rely on certain types of current risk management practices.

Ultimately, interpretation of the parameters of the bona fide hedging exception may also have an impact upon separate rulemaking initiatives regarding (i) the commercial end user exception to mandatory clearing (The CFTC's proposed rules were issued on December 23, 2010.) and (ii) the definition of a "major swap participant" (The CFTC's and the SEC's joint proposed rules on entity definitions were issued on December 21, 2010.). In analyzing whether a position hedges or mitigates commercial risk for such purposes, both sets of proposed rules look to whether a transaction constitutes a bona fide hedge for purposes of the Position Limit Rules in addition to analyzing elements similar to those listed under items (ii) and (iii) above. Final rules regarding both the commercial end user exception and the entity definitions are on the CFTC's proposed rulemaking timeline for the remainder of 2011 (although, as noted above, it is possible these may be delayed, and the rules may be revised prior to finalization), and perhaps the final rules will clarify whether these two tracks of analysis continue in parallel or diverge. The Release discusses this overlap but emphasizes that swaps may nonetheless qualify for one but not the other.

Pre-Existing Position Exemption

Non-spot month position limits will not apply to pre-existing positions in Referenced Contracts that were entered into in good faith prior to the effective date of the initial position limits established pursuant to the Position Limit Rules, although spot month position limits will apply to such pre-existing positions.

In the Release, the CFTC clarified that pre-existing positions in excess of the non-spot month position limits would not result in a violation based solely on those positions, but to the extent pre-existing positions cause a trader to exceed a non-spot month position limit, such trader would not be permitted to increase its position so as to further exceed such position limit.

Aggregation of Positions; Independent Account Controller Exemption

For purposes of the Position Limit Rules, a "trader" is defined as a person that makes transactions in Referenced Contracts or has such transactions made, for its own account or for an account that it controls.

The Position Limit Rules will require aggregation of positions in multiple accounts for which an entity has direct or indirect control, which are controlled by two or more persons acting pursuant to an express or implied agreement, or which are subject to identical trading strategies (meaning that positions in passive index funds, for example, would need to be aggregated); provided that an existing exemption for accounts of affiliated entities controlled by an "*independent account controller*" ("**IAC**") will be retained.

The IAC exemption permits certain entities not to aggregate client positions with those of affiliates if such positions are controlled by an IAC that trades independently, has no knowledge of trading decisions by any other IAC, and is appropriately registered with (or exempt from registration with) the CFTC.

Position Visibility Reporting

The Position Limit Rules will require quarterly reporting for traders holding or controlling net long or short positions in certain energy and metal Referenced Contracts that exceed specified levels in all months combined or in any single month (including the relevant spot month). Such quarterly reports must include information regarding the traders' gross long and short positions in the relevant Referenced Contracts.

Political Backdrop; Commissioners' Statements

The adoption of the Position Limit Rules represents the culmination of one of the more controversial and hotly debated rulemaking processes undertaken by the CFTC pursuant to the Dodd-Frank Act[9]. The CFTC observed that it had received more than 15,000 comment letters regarding the Proposed Rules, and the final Position Limit Rules were ultimately approved by a strict party-line vote of 3-2, with Chairman Gary Gensler and Commissioners Bart Chilton and Michael Dunn (in his last vote as a Commissioner before stepping down) voting in favor and Commissioners O'Malia and Sommers dissenting.

Well-publicized dramatic swings in energy, food, and other commodity prices over the past several years, combined with growth in the market for commodity-related exchange-traded products and funds, have resulted in a great deal of public pressure to curb speculation in commodities as a means to manage price fluctuations and their damaging effects upon consumers, businesses, and the economy. At the same time, many comment letters and market participants have observed that many other factors have contributed to the price swings observed, and that there is limited, if any, evidence that speculation in the form of derivatives is responsible.

In his statement of dissent at the CFTC's October 18 meeting, Commissioner O'Malia expressed concern that the CFTC had acted without making a required determination that the position limits are necessary and effective in relation to the identifiable burdens of excessive speculation on interstate commerce. He also argued that the Position Limits Rule fails to provide a legally sound, comprehensible rationale based on empirical evidence.

Commissioner Dunn, meanwhile, noted in his opening statement that position limits are "the sideshow that has unnecessarily diverted human and fiscal resources away from actions to prevent another financial crisis," and that "no one has presented to this agency any reliable economic analysis to support either the contention that excessive speculation is affecting the markets we regulate or that position limits will prevent excessive speculation... my fear is that position limits are, at best, a cure for a disease that does not exist or a placebo for one that does." Nonetheless, Commissioner Dunn voted in favor of the Position Limit Rules on the basis that the CFTC had a clear mandate from Congress to impose position limits, while "commend[ing] staff for drafting a rule that will hopefully do as little harm to the market as possible."

Following the adoption of the Position Limit Rules, as part of its continuing investigation into speculation in the commodities markets, the Senate Permanent Subcommittee on Investigations held a hearing on November 3, 2011 to further examine the role of speculation in the commodity markets and the impact of the Position Limit Rules. In their opening statements, the Subcommittee Chairman, Senator Carl Levin, highlighted the impact of investments made in connection with commodity index funds, exchange-traded products, and mutual funds,[10] while the Ranking

[9] See Jeremy Grant, "Watershed for CFTC as Politics on Display," *Financial Times*, Oct. 18, 2011, available at: http://www.ft.com/intl/cms/s/0/cb1e142e-f9b6-11e0-8e7e-00144feab49a.html.
[10] Senator Levin indicated that the Internal Revenue Service ("**IRS**") was studying the practices of certain mutual funds that have made investments in offshore special purpose companies that trade in commodities, which could threaten the status of private-letter rulings issued in

Member, Senator Tom Coburn, emphasized the need for regulators to be mindful of the public interest and to base decisions on facts and data rather than act reflexively to place restrictions on unpopular market participants. Senator Coburn also reiterated the observation made by Commissioner Sommers and various media observers[11] that the Position Limit Rules may be challenged in court.

For more information, please contact:

Brian Y. Sung
212.659.4964
brian.sung@haynesboone.com

Jeff Nichols
713.547.2052
jeff.nichols@haynesboone.com

connection with such investments. If such investments are deemed to be investments in commodities rather than in securities, IRS rules that require mutual funds to earn at least 90 percent of their income from securities rather than alternative sources such as commodities could restrict mutual funds' commodity investments.

[11] See "CFTC Heads for Showdown with Industry in Court," Reuters, Oct. 17, 2011, available at: http://newsandinsight.thomsonreuters.com/Legal/News/2011/10_-_October/CFTC_heads_for_showdown_with_industry_in_court/.