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E-ALERT | Dodd-Frank Act

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CFTC ISSUES PROPOSED RULES SETTING POSITION LIMITS FOR COMMODITY DERIVATIVES

The Commodity Futures Trading Commission ("CFTC") voted Thursday to propose a framework for implementing position limits for energy, metals, and agricultural derivatives under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The Notice of Proposed Rulemaking ("NOPR") outlines the position limits regime to be set in two phases for 28 core physical-delivery contracts and their economically equivalent swaps. The NOPR also defines the bona fide hedge exemption, provides for the treatment of positions established prior to the new limits' effective date, and discusses how positions are to be aggregated among common owners. Finally, the NOPR implements visibility regulations that trigger reporting obligations over certain thresholds. The NOPR contains the same position limits rule and bona fide hedge exemption that the CFTC considered, but did not vote on, last month before adjourning its December 16th rulemaking meeting.

DODD-FRANK'S POSITION LIMITS AUTHORITY

Title VII of Dodd-Frank sets forth a comprehensive new regulatory framework for derivatives. As part of this framework, Section 737 of Dodd-Frank amends Section 4a of the Commodity Exchange Act to expand the CFTC's authority to set position limits. Specifically, Dodd-Frank requires the CFTC to establish, as appropriate:

- Position limits with respect to commodity futures and option contracts in exempt and agricultural commodities traded on or subject to the rules of a designated contract market ("DCM"), and
- Position limits, including aggregate position limits, for swaps that are economically equivalent to DCM contracts in exempt and agricultural commodities. These limits must be imposed simultaneously with limits on DCM contracts.

Dodd-Frank requires the CFTC to adopt position limits for exempt commodities (*e.g.*, energy and metals) within 180 days of its enactment, and for agricultural commodities, within 270 days.

Section 737 further provides that the CFTC shall establish aggregate limits across contracts listed by DCMs, linked contracts listed on a Foreign Board of Trade that allows direct access to U.S. customers, and swap contracts that perform a significant price discovery function. The NOPR indicates that the Commission intends to address limits for swaps that serve a significant price discovery function in a subsequent notice of proposed rulemaking.

CFTC'S PROPOSED POSITION LIMITS RULES

Physical Commodities

The NOPR establishes position limits on 28 core physical-delivery contracts and their economically equivalent contracts, listed as "referenced contracts" in proposed new regulation 151.2. These contracts include the following:

- *Energy commodities*, such as NYMEX Light Sweet Crude Oil, NYMEX New York Harbor No. 2 Heating Oil, NYMEX New York Harbor Gasoline Blendstock, and NYMEX Henry Hub Natural Gas.
- *Metals commodities*, such as certain gold, silver, copper, palladium, and platinum contracts.
- *Agricultural commodities*, such as certain corn, oats, rice, soybeans, wheat, cattle, hogs, milk, cocoa, coffee, orange juice, sugar, and cotton contracts.

Phased Implementation

In light of Dodd-Frank's rulemaking deadlines, the CFTC proposed to adopt position limits in two phases. During the first phase, the CFTC would establish spot-month position limits at the levels currently imposed by DCMs, and would also adopt related provisions, including its definition of bona fide hedging. During the second phase, the CFTC would establish single-month and all-months-combined position limits and set its own spot-month limits. The CFTC proposed to delay this phase until it is able to collect relevant data on open interest levels in swap markets.

Spot-Month Limits

The proposed rules set spot-month position limits at 25% of deliverable supply or five times that amount in exclusively cash-settled contracts for entities holding a physical position less than 25% of the deliverable supply. A trader with positions in both the cash-settled and physically delivered contracts could hold up to the spot-month limit in each contract. In the first phase of implementation, the CFTC proposed to adopt DCM estimates of deliverable supply. In the second phase, the CFTC proposed to determine deliverable supply itself, although it may still rely on DCM estimates.

Non-Spot-Month Position Limits

The NOPR indicates that the CFTC does not currently have the data needed to fix position limits outside the spot month. Instead, the NOPR proposes the formulas to be used and states that the CFTC will finalize the actual limits once it has the necessary data.

The proposed rules set non-spot-month position limits for each referenced contract at 10% of open interest in that contract up to 25,000 contracts and 2.5% thereafter. Non-spot-month position limits would consist of aggregate single-month and all-months-combined limits that would apply both across classes and also individually for each of the following two classes: (1) DCM futures and options, and (2) all swaps.

According to the NOPR, the proposed aggregate limits would apply to positions in referenced contracts executed on foreign boards of trade offering direct access on linked contracts.

Further, the proposed rules include legacy position limits for certain agricultural contracts listed in Regulation 150.2. The proposed rules retain the all-months-combined limits for these contracts and increases the single-month limits, so that they equal the all-months-combined limits.

Given that single-month and all-months-combined position limits are not currently in place for energy and metals markets, the CFTC requests comment on whether those limits should initially be set at a higher level (*e.g.*, 10% of open interest for the first 25,000 contracts, and 5% thereafter) to ensure that hedging and price discovery are not adversely affected.

Aggregation and Netting of Positions

Under the proposed regime, position limits would apply to all positions in which a trader, directly or indirectly, has an ownership interest greater than 10% or, by power of attorney or otherwise, controls trading. Further, in determining a trader's non-spot-month and all-months combined positions, positions across contracts of the same class shall be netted.

Bona Fide Hedging Exemption

Under Dodd-Frank, a trade may exceed position limits set by the CFTC if it is a bona fide hedging transaction. Tracking Dodd-Frank's language, the proposed rule defines "bona fide hedging" as a transaction or position that:

- Represents a substitute for transactions in a physical marketing channel;
- Is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and
- Arises from the potential change in the value of assets, liabilities, or services.

Alternatively, the transaction or position would qualify for bona fide hedging treatment if it reduces risks resulting from a swap executed opposite a counterparty for which the transaction would qualify as bona fide hedging under the above test, or if it reduces risks resulting from a swap that satisfies the above test.

Position Visibility Reporting Regime

In order to monitor large positions for metals and energy contracts, the CFTC further proposed to implement a position visibility regime similar to current reporting obligations for large traders. If a trader holds or controls positions in referenced contracts that exceed the proposed visibility levels, the trader must submit additional information regarding its cash market and derivatives activity, including positions in substantially the same commodity. The CFTC approximates that over the course of the year, 20 unique owners would reach the proposed visibility levels for most contracts, and 30 unique owners would reach the visibility levels set for NYMEX Light Sweet Crude Oil and Henry Hub Natural Gas which have relatively lower levels.

Interim Monitoring of Large Positions

In a separate statement, Chairman Gary Gensler directed the CFTC staff to collect information about large positions before single-month and all-months-combined position limits can be fully implemented. Specifically, staff will monitor traders who have positions above the 10% and 2.5% levels proposed for the 28 core contracts. Staff will brief the Commissioners about these positions on a monthly basis and recommend appropriate action based on the CFTC's existing enforcement authority. Chairman Gensler explained that the interim monitoring program will provide information regarding how proposed limits will affect the market.

The proposed rule is available here. Comments are due 60 days after the proposed rule is published in the *Federal Register*, which has not yet occurred.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our firm:

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