CFTC Adopts Final Rule Regarding Speculative Position Limits

December 22, 2020

On October 15, the Commodity Futures Trading Commission (CFTC or the Commission) adopted final rules imposing speculative position limits in derivative contracts referencing 25 agricultural, metals and energy commodities (the Final Rules). These limits are the culmination of almost a decade of work from the Commission and its staff, including revising the rules after a federal court vacated its last attempt to expand speculative position limits in 2012.

The Final Rules are intended to "prevent excessive speculation" and broadly apply to positions in futures, options and economically equivalent swaps referencing the covered commodities (Covered Contracts). The Final Rules approach the exemption for bona fide hedges flexibly, to "accommodate potential future, unpredictable developments in commercial hedging practices." This is in contrast to previous rule proposals, which were both more prescriptive and restrictive. The Final Rules also exempt certain recognized spread transactions.

Although the Final Rules have a relatively distant compliance date (January 1, 2022, for futures contracts in the 16 commodities not subject currently to federal limits and January 1, 2023, for economically equivalent swaps), market participants should familiarize themselves with the Final Rules and their exemptions because many participants and intermediaries will likely find it necessary to establish internal control procedures, which may require systems development in advance of the Final Rules' compliance date. The Commission has long prioritized enforcement actions based on violations of existing federal and exchange-set position limits, and we expect this focus to continue with the adoption of this broadened speculative position limits regime.

I. Relevant Background

Since its adoption in 1936, Section 4a of the of the Commodity Exchange Act has authorized the Commission to impose speculative position limits.[1] Section 737 of the 2008 Dodd-Frank Wall Street Reform and Consumer Protection Act amended Section 4a to expand the Commission's authority to impose speculative positions limits "as necessary." The CFTC first attempted to adopt rules under this new authority in 2011.[2] However, these rules were largely vacated by a federal court in 2012, after the court found the Commission had not appropriately determined that the position limits adopted were necessary to advance the statute's goals.[3]

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[1] 7 U.S.C. § 6a.
[2] *See* Position Limits for Futures and Swaps, 76 Fed. Reg., 71,626 (Nov. 18, 2011).
[3] *See ISDA v. CFTC*, 887 F. Supp. 2d 259 (D.D.C. 2012).

In the eight years following this setback, the CFTC proposed several iterations of revised speculative position limit rules that were designed to address the issues in the original 2011 rules. The first of the revised rules were noticed for comment in December 2013. In response to comments from market participants and other commenters, the Commission issued a supplemental proposal in June 2016, followed by a complete re-proposal in December of that year. In February 2020, the Commission issued a further revised proposal, which specifically found that the proposed position limits were necessary to prevent excessive speculation. The Final Rules adopt the February 2020 proposal with few material changes.

II. Summary of the Rulemaking

The Final Rules become effective upon publication in the Federal Register. Market participants must comply with applicable position limits for futures and options contracts not currently subject to federal limits by January 1, 2022, and for economically equivalent swaps by January 1, 2023.

A. Overall Structure of Speculative Position Limits

The Final Rules amend the overall framework for speculative position limits by building on the current structure that applies to the agricultural contracts currently subject to federal limits (the Legacy Contracts). These nine agricultural commodities[4] will continue to be subject to spot-month and combined single-month and all-month limits, using a formula based on 25 percent of the current estimated deliverable supply. The spot-month limits for most of these commodities have been increased from their existing levels, reflecting increases in the deliverable supply.

Amended Regulation 150.2 also continues to impose non-spot-month limits for these contracts. The formula is 10 percent of open interest for the first 50,000 contracts, with an incremental increase of 2.5 percent of open interest thereafter adjusted by the size of the unit of trading. Most of these levels have also been adjusted upward to reflect increased open interest in these contracts.

The remaining Covered Contracts are subject only to spot-month limits at the federal level. Specifically, the Final Rules amend Regulation 150.2 to establish federal spot-month position limits for derivative contracts referencing 16 agricultural, metals and energy commodities not covered by the Commission's existing position limits. As with the Legacy Contracts, these limits are based on 25 percent of the current estimated deliverable supply for the relevant commodity, as reported by the designated contract market listing the core referenced futures contract.[5]

For all Covered Contracts, these limits apply separately to positions in physically and cash-settled products. Market participants must aggregate, and net, positions in contracts within each delivery type.[6] These limits also apply to cash-settled futures and options contracts that are either "directly or indirectly" linked to the price of a "core referenced futures contract" or the same commodity, "for delivery at the same location as specified in that core referenced futures contract," but exclude certain index and average-price contracts, including location basis contracts, commodity index contracts and calendar month average contracts.

In addition, these limits apply to "economically equivalent swaps" entered after the effective date of the Final Rules that "have identical material specifications, terms, and conditions" to a "core referenced futures contract" or covered cash-settled contract, even if the swap provides a different lot size or notional value, post-trade risk management arrangement, or, for physically settled

[4] They are CBOT Corn, CBOT Oats, CBOT Soybeans, CBOT Wheat, CBOT Soybean Oil, CBOT Soybean Meal, MGEX Hard Red Spring Wheat, ICE Cotton No. 2 and CBOT KC Hard Red Winter Wheat.

[5] While these limits do not automatically adjust, we expect that the Commission will take action to increase or decrease these limits if the deliverable supply of a covered commodity changes materially.

[6] For the NYMEX Henry Hub Natural Gas (NYMEX NG) physically delivered core referenced futures contract and its associated cash-settled referenced contracts, federal position limits apply to NYMEX NG cash-settled referenced contracts and are not aggregated across different exchanges.

swaps, delivery dates that diverge by less than one calendar day from the equivalent futures contract.[7]

A table reflecting the Covered Contracts subject to these amended position limits is provided below.

Legacy Agricultural (spot- and back- months federal limits)	Non-Legacy Agricultural	Metals	Energy
CBOT Corn	CBOT Rough Rice	COMEX Gold	NYMEX Henry Hub Natural Gas[8]
CBOT Oats	ICE Cocoa	COMEX Silver	NYMEX Light Sweet Crude Oil
CBOT Soybeans	ICE Coffee C	NYMEX Copper	NYMEX New York Harbor ULSD Heating Oil
CBOT Wheat	ICE FCOJ-A	NYMEX Platinum	NYMEX New York Harbor RBOB Gasoline
CBOT Soybean Oil	ICE US Sugar No. 11	NYMEX Palladium	
CBOT Soybean Meal	ICE US Sugar No. 16		
MGEX Hard Red Spring Wheat	CME Live Cattle		
ICE Cotton No. 2			
CBOT KC Hard Red Winter Wheat			

B. Exchange Position Limits

The Final Rules amend Regulation 150.5 to require designated contract markets (DCMs) to establish speculative position limits for Covered Contracts.[9] This expands DCMs' obligations under existing Regulation 150.5, which currently only requires DCMs to establish position limits for contracts not already subject to federal position limits. Under these amended rules, DCMs must set spot-month speculative position limits for Covered Contracts and non-Covered Contracts that are "no greater than 25 percent of the estimated spot month deliverable supply" for the relevant commodity. However, the Final Rules give DCMs discretion to submit rules to the Commission that would implement alternative calculation methodologies if the DCM determines that such levels are "necessary and appropriate to reduce the potential threat of market manipulation or price distortion of the contract's or the underlying commodity's price or index."

For Covered Contracts subject to federal position limits outside the spot month (i.e., Legacy Contracts), DCMs, as currently required, are also required to establish position limits "no higher" than the federal position limit. For all other contracts, DCMs are required to "adopt either speculative position limits or position accountability outside of the spot month at a level that is necessary and appropriate to reduce the potential threat of market manipulation or price distortion of the contract's or the underlying commodity's price or index." This framework builds on the current relationship between Commission-set and exchange-set position limits.

[7] Physically settled natural gas swaps may have delivery dates that diverge by less than two calendar days from the relevant core referenced futures contract.

[8] The Final Rules allow a market participant that holds no physically settled NYMEX NG contracts to "exceed the federal spot month position limit level of 2,000 cash-settled referenced contracts per exchange (and an additional 2,000 equivalent-sized economically equivalent OTC swaps) by holding 10,000 cash-settled NYMEX NG referenced contracts per designated contract market, as well as an additional 10,000 equivalent-sized cash-settled economically equivalent NYMEX NG swaps." Market participants may not use a spread exemption to exceed the aforementioned conditional spot-month limit for natural gas.

[9] The Commission is delaying compliance with exchange-set position limits regarding swaps.

C. Exemptions

The Final Rules provide several important exemptions and exceptions to federal and exchange position limits.

1. Bona Fide Hedges

The position limits established by the Final Rules exclude “bona fide hedging transactions” that (1) provide a temporary substitute for future transactions in physical commodities, (2) that are economically appropriate to reduce price risks for a commercial enterprise and (3) that “arise from the potential change in value of actual or anticipated assets, liabilities, or services.” A transaction must satisfy each of these elements to qualify as a bona fide hedge. General risk management activities, including for futures commission merchants or other intermediaries, that do not meet each element are not excluded from the Commission’s speculative position limits.

The Final Rules expressly recognize several enumerated transactions that satisfy these requirements, including hedges of fixed-price cash commodity sales contracts, hedges of unfilled requirements or unsold production, and hedges of anticipated services or merchandising. In addition, the Final Rules provide two mechanisms for market participants to seek confirmation that other hedging arrangements meet this definition.

First, market participants may file an application directly with the Commission.[10] Such an application must explain the participant’s “hedging strategy, including a statement that the applicant’s position complies with the applicable requirements of the bona fide hedge definition” and “information that demonstrates why the position satisfies the applicable requirements.” Exemptions obtained through this process remain valid indefinitely, unless there are any material changes to the original application or if the Commission determines that the hedging strategy no longer qualifies as a bona fide hedge. However, participants relying on this process must also separately apply for an exemption from the relevant exchange limits. This replicates the current exemption process.

Second, the Final Rules establish an innovative approach to exemptive relief, providing a streamlined process for simultaneously applying to the relevant DCM for an exemption from *both* the federal and exchange-set position limits. To participate in this process, DCMs may adopt rules establishing a protocol for reviewing and granting non-enumerated hedge exemptions. If an exchange elects to participate, these rules must conform to the Commission’s standards for recognizing bona fide hedges, including prohibiting the accumulation of positions that “would not be in accord with sound commercial practices in relevant commodity market.” Applications approved by a DCM will automatically apply to that exchange’s position limits. These approvals will also automatically be deemed to apply to federal position limits if the Commission does not object within 10 business days or stay the approval of the application for further review. If the Commission determines to stay the application, it must issue a decision within 45 days. Market participants may not exceed federal position limits during this review, but they are not required to reduce their positions below the position limit if they have already exceeded the applicable federal limit during the Commission’s 10-day review period or as part of a retroactive application. Unlike approvals obtained directly from the CFTC, approvals obtained through this streamlined process must be renewed at least annually. This approach, although not a formal delegation of the Commission’s exemptive authority, grants the exchanges an unprecedented role in these determinations.

In addition, a swap dealer or other swap counterparty may rely on the bona fide hedge exemption for “pass-through swap offsets” and “pass-through swaps” that facilitate a counterparty’s bona fide hedge. To qualify for this exemption, the pass-through swap counterparty must receive a written representation from the bona fide hedging swap counterparty to demonstrate the applicability of the bona fide hedging exemption. The pass-through swap counterparty could then exceed the federal

[10] Market participants with existing position limits exemptions (other than risk-management exemptions) do not need to reapply under this new framework.

position limits for the swap opposite the bona fide hedging swap counterparty, despite the position's not independently qualifying as a bona fide pass-through hedge.[11]

2. Spread Transaction Exemption

The Final Rules amend Regulation 150.3 to provide a self-effectuating exemption for enumerated spread transactions, so long as the market participant applies to the applicable exchange for a spread exemption from the exchange-set position limits. This relief is intended to apply to "most, if not all, spread strategies currently granted by exchanges and used by market participants" and includes intra- and inter-market spreads, intra- and inter-commodity spreads, calendar spreads, and product or by-product differential spreads.

In addition, the Final Rules allow market participants with spread positions that do not fit within the examples enumerated in the "spread transaction" definition to apply to the Commission for recognition of a new exemption. This process must be completed before a participant exceeds any applicable position limits. The Commission declined requests from commenters to allow these requests to be handled by exchanges in the same manner as the streamlined process for approving new bona fide hedges described above.

3. Financial Distress Exemption

Under the Final Rules' "financial distress" exemption, the CFTC may, upon request, exempt any person under financial distress from any applicable position limits. The Commission indicated that the types of circumstances that could qualify for financial distress would include the potential default or bankruptcy of a customer, an affiliate of the requestor or a potential acquisition target of the requestor. We expect that this exemption will be used sparingly and only in cases that could result in significant market disruption in the event of a forced liquidation.

III. Conclusion

The adoption of the Final Rules is a major milestone in the Commission's regulatory agenda and one of the final steps in fully implementing the authority delegated to the Commission under the Dodd-Frank Act. The approach reflected in the Final Rules appears designed to balance the Commission's interest in ensuring market stability and avoiding excess speculation, while not overly burdening bona fide commercial risk management activities and recognized spread transactions. While this flexible approach will likely be received better than some of the Commission's prior attempts to regulate this space, it delegates significant decision-making authority to the DCMs that list Covered Contracts. Although the Commission has veto power over these decisions, it remains to be seen how actively the Commission will police DCMs' decisions on bona fide hedge exemptions and whether this decentralized approach will create any inconsistencies between Covered Contracts listed on different exchanges.

In addition, we expect that the Commission will continue to prioritize compliance with federal and exchange position limits and that compliance with the Final Rules will become a high priority of the Division of Enforcement after their effective date. Entities that may be subject to these restrictions should begin considering whether and how to enhance their existing supervisory systems and control environments to ensure that they have accurate and timely information about their aggregate positions in Covered Contracts to ensure compliance going forward.

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[11] In response to several questions from commenters, the Commission confirmed that this relief is available to corporate affiliates that aggregate positions under Regulation 150.4. Accordingly, a swap dealer could claim a bona fide hedge exemption for a transaction entered with a corporate treasury affiliate, even if the risk being hedged was incurred by another entity in the same corporate family.

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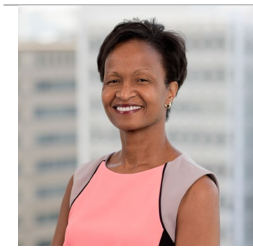

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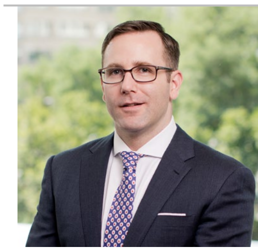

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