CLIENT ALERT

CFTC Proposes to Expand Position Limits for Derivatives, Ease Hedge Exemption Standards

FEBRUARY 12, 2020

On January 30, 2020, the Commodity Futures Trading Commission ("**CFTC**") held an open meeting where it approved, on a 3-2 vote, a proposed rule addressing Position Limits for Derivatives ("**Proposed Rule**").[1] The Proposed Rule replaces the CFTC's previously proposed position limits regulations: *i.e.*, the 2011 proposed[2] and final[3] rules, the 2013 proposal,[4] the June 2016 supplemental proposal,[5] and the December 2016 re-proposal.[6] The Proposed Rule also expands the scope of the related 2016 final rule[7] addressing amendments to the rules governing aggregation of positions for purposes of compliance with federal position limits.

In a number of ways, the Proposed Rule takes a different approach to the CFTC's prior proposals related to position limits, as well as its currently effective rules on the subject. Most notably, and as explained further below, the Proposed Rule would expand upon the list of federally recognized bona fide hedge exemptions; allow market participants to work with exchanges to obtain initial approval of such hedge exemptions (subject to the CFTC's right of rejection); and require the CFTC to make a necessity finding before establishing new position limits for physical commodities.

In General

Among other amendments, the Proposed Rule includes new and amended federal spot month limits for "**Referenced Contracts**." Referenced Contracts include: (1) 25 physically settled commodity futures contracts (the "**Core Referenced Futures Contracts**" or "**CRFCs**"); (2) cash-settled futures and options on futures linked to a CRFC; and (3) swaps that are economically equivalent to another Referenced Contract.

Nine of the CRFCs are agricultural contracts that are currently subject to federal position limits. The other CRFCs include seven additional agricultural contracts, four energy contracts, and five metals contracts, all of which would be newly subject to federal position limits. Referenced Contracts would also include futures and options on futures that are directly or indirectly linked to the price of a CRFC or to the same commodity underlying a CRFC at the same delivery location. Location basis contracts, commodity index contracts, swap guarantees, and trade options that meet certain requirements would be excluded from this category, however.

Finally, Referenced Contracts would include swaps with "identical material" contractual specifications, terms, and conditions to a CRFC or linked contract. Of note, the CFTC stated that a swap would not be considered to have identical material terms (and therefore would not be a Referenced Contract) if its settlement type (*e.g.*, cash- versus physically settled) differed from any relevant Referenced Contracts. Therefore, a cash-settled swap could only be deemed economically equivalent to a cash-settled Referenced Contract, and a physically settled swap could only be deemed economically equivalent to a physically settled Referenced Contract.

The Proposed Rule would impose federal position limits on all Referenced Contracts (including economically equivalent swaps) in the spot month, but would only impose position limits outside of the spot month on the nine legacy agricultural contracts. All other Referenced Contracts would only be subject to exchange-set limits and/or position accountability levels outside of the spot month.

The CFTC stated that it would oversee compliance with position limits on swaps, and that it would delay the requirement for futures exchanges and swap execution facilities to establish position limits for swaps until such exchanges have access to sufficient data to monitor compliance with limits on swaps across exchanges.

Hedge Exemptions

The Proposed Rule contains certain exemptions from position limits, including a revised definition of "bona fide hedging transactions or positions" with an accompanying expanded list of enumerated hedges intended to cover additional hedging practices. Notably, the Proposed Rule would expand the current list of enumerated bona fide hedges to cover hedging practices first recognized by the December 2016 re-proposal, as well as the newly recognized hedge of anticipated merchandising (which would be subject to certain conditions). For Referenced Contracts, enumerated hedge exemptions would be self-effectuating, so no application to the CFTC would be required. Market participants relying on an enumerated hedge exemption would still need approval from the relevant futures exchange, however.

The Proposed Rule also establishes a new process to streamline requests for non-enumerated bona fide hedge exemptions for both exchange-set and federal position limit requirements. Specifically, market participants would be able to either apply for a non-enumerated hedge exemption directly to the CFTC, or to apply to the relevant futures exchange. In the latter case, a futures exchange would be required to notify the CFTC (and the applicant) after it approves a non-enumerated bona fide hedging exemption, and the CFTC would have 10 business days (or two business days in the case of sudden or unforeseen bona fide hedging needs) to review and reject the exchange determination.

Separately, the Proposed Rule would cease to recognize "risk management" positions as bona fide hedges for physical commodities, but the CFTC encouraged intermediaries that previously relied on that exemption to consider whether their activity would qualify as a bona fide hedging position in other ways, including as a pass-through swap. Under that exemption, the bona fides of a hedging position "pass through" from the bona fide hedging counterparty to the other counterparty if: (1) the pass-through counterparty can demonstrate (upon a request from the CFTC and/or exchange) that a swap is a bona fide hedge, and (2) the pass-through counterparty enters into a derivatives position in the same physical commodity as the pass-through swap to offset and reduce the risk attendant to the pass-through swap. Of note, futures exchanges could continue to recognize risk management positions for contracts not subject to federal position limits.

Finally, the Proposed Rule would eliminate the requirement to submit monthly cash-market reporting on Form 204 (as well as Forms 304, 504, 604, and 704); the CFTC would instead rely on the information submitted by market participants to the exchanges in connection with their applications for exemptions from exchange-set limits, which are typically filed on an annual basis.

Necessity Finding

Unlike prior proposals, the Proposed Rule interprets the statutory language providing for position limits (*i.e.*, requiring the CFTC to establish position limits as it "finds are necessary to diminish, eliminate, or prevent" certain burdens on interstate commerce) in a way that would require the CFTC to make a necessity finding before establishing position limits on any new contracts. The Proposed Rule therefore includes a preliminary determination that federal position limits are necessary for the 25 CRFCs and any associated Referenced Contracts, but not any other futures or swap contracts. Therefore, under the Proposed Rule, the CFTC would need to find that it is necessary to expand the list of CRFCs before doing so.

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Comments on the Proposed Rule are due on or before April 29, 2020.

Public comments can be submitted and viewed on the CFTC website.[8] More information about the Proposed Rule may be found in the CFTC Fact Sheet[9] and the CFTC press release.[10]

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1 The text of the voting draft of the Proposed Rule can be found on the CFTC's website at https://www.cftc.gov/media/3366/federalregister013020b/download.

2 Position Limits for Derivatives, 76 Fed. Reg. 4752 (proposed Jan. 26, 2011) (to be codified at 17 C.F.R. pts. 1, 150, and 151).

3 Position Limits for Futures and Swaps, 76 Fed. Reg. 71626 (Nov. 18, 2011) (to be codified at 17 C.F.R. pts. 1, 150, and 151).

4 Position Limits for Derivatives, 78 Fed. Reg. 75680 (proposed Dec. 12, 2013) (to be codified at 17 C.F.R. pts. 1, 15, 17, 19, 32, 37, 38, 140, and 150).

5 Position Limits for Derivatives: Certain Exemptions and Guidance, 81 Fed. Reg. 38458 (proposed June 13, 2016) (to be codified at 17 C.F.R. pts. 37, 38, and 150).

6 Position Limits for Derivatives, 81 Fed. Reg. 96704 (proposed Dec. 30, 2016) (to be codified at 17 C.F.R. pts. 1, 15, 17, 19, 37, 38, 140, 150, and 151).

7 Aggregation of Positions, 81 Fed. Reg. 91454 (Dec. 16, 2016) (codified at 17 C.F.R. pt. 150).

8 Comments may be viewed and submitted online at https://comments.cftc.gov/PublicComments/ReleasesWithComments.aspx.

9 *Available at* https://www.cftc.gov/media/3376/NPRMPositionLimits_factsheet013020/download.

10 *Available at* https://www.cftc.gov/PressRoom/PressReleases/8112-20.

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