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CFTC Re-Proposes Speculative Position Limit Rules for Futures, Options and Swaps on Physical Commodities

On November 5, 2013, the Commodity Futures Trading Commission (CFTC) voted 3-1 to re-propose rules to establish speculative position limits for futures, options and economically equivalent swaps on certain agricultural, metal and energy commodities. The CFTC previously had adopted speculative position limit rules in October 2011 based on new authority provided under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). However, just two weeks before the final rules were to become effective, the U.S. District Court for the District of Columbia vacated and remanded the CFTC rules.[1]

More than one year after the district court's decision, the CFTC has decided to propose substantially similar rules to the vacated rules. If finalized, the proposed rules would impose federal limits on speculative positions in each of 28 core referenced futures contracts (listed in Table 1 on page 14) as well as on speculative positions in futures, options and swaps that are directly or indirectly linked to the 28 core referenced futures contracts. The proposed CFTC position limits would not apply to commodity derivative contracts[2] in excluded (*i.e.*, non-physical) commodities. However, the proposed rules include a definition for bona fide hedging for excluded commodity derivative contracts — in addition to a bona fide hedging exemption and other exemptions for physical commodity derivatives — that the CFTC claims to be narrower in certain respects than the vacated rules and current bona fide hedging concept. In addition, the proposed rules would expand the circumstances in which a person must aggregate his positions with the positions held by another for purposes of determining compliance with position limits. The proposed rules also would establish requirements and acceptable practices for designated contract markets (DCMs) and swap execution facilities (SEFs) to set position limits and/or position accountability levels for contracts executed on their markets. This client alert summarizes the key aspects of the CFTC's re-proposed position limits and aggre-gation rulemakings.

The official comment period on the CFTC's proposed aggregation rules is open until January 14, 2014.[3] The official comment period for all other aspects of the CFTC's proposed speculative position limit rules is open until February 10, 2014.[4]

Until the CFTC puts new speculative position limit rules into effect, market participants must continue to comply with the existing CFTC Part 150 position limit regime and position limits or accountability levels currently imposed by DCMs or SEFs.[5]

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1 *See International Swaps and Derivatives Association, et al. v. United States Commodity Futures Trading Commission*, 887 F. Supp. 2d 259 (D.D.C. Sept. 28, 2012).

2 The proposed rules would define a "commodity derivative contract," to mean "any futures, option, or swap contract in a commodity (other than a security futures product as defined in section 1a(45) of the [CEA])." *See* 78 Fed. Reg. at 75824.

3 *See* Aggregation of Positions, 78 Fed. Reg. 68,946 (Nov. 5, 2013).

4 *See* Position Limits for Derivatives, 78 Fed. Reg. 75680 (Dec. 12, 2013).

5 The current CFTC position limits only apply to futures contracts in nine agricultural commodities and options on those futures. DCMs impose spot-month position limits for futures contracts (and options thereon) in commodities beyond those nine agricultural commodities. Outside of the spot month, DCMs generally use position accountability levels to protect markets from abuses such as manipulation or congestion. Position accountability rules, unlike hard position limits, are flexible tools that DCMs can use to gather information from traders whose positions exceed accountability levels and, if necessary, to require such traders to halt from increasing their positions further.

What is the CFTC's Basis for Imposing Speculative Position Limits?

The CFTC's statutory position limits authority is found in Section 4a of the Commodity Exchange Act (CEA), as amended by Dodd-Frank. Even prior to Dodd-Frank, Section 4a(a)(1) of the CEA provided the CFTC with the authority to impose position limits "from time to time" "as the [CFTC] finds are necessary to diminish, eliminate or prevent [burdens arising from excessive speculation]." Dodd-Frank did not change this language, but added, among other amendments, language that "in accordance with the standards set forth [in Section 4a(a)(1)]," the CFTC shall set limits on speculative positions in physical commodity futures and options "as appropriate."[6]

As the CFTC had asserted in justifying its position limit rules that were vacated, the CFTC states in its re-proposal that, through Dodd-Frank, "Congress made the decision to impose limits, and it is for the Commission to carry that decision out, subject to close congressional oversight."[7] However, unlike its rationale for the vacated rules, where the CFTC claimed that this congressional mandate was unambiguous, the CFTC acknowledges the D.C. district court's holding that the Dodd-Frank amendments left unclear whether the CFTC must impose position limits without making a finding that such limits are necessary. According to the CFTC, the "better reading" is that "the Dodd-Frank amendments require the Commission to impose position limits on physical commodity derivatives" without first making a finding of necessity or appropriateness.[8]

In addition, as a "separate and independent basis" for its proposal, the CFTC now makes a preliminary finding that the proposed position limits are necessary to achieve their statutory purposes.[9] Notably, the CFTC's necessity findings in its proposal are not particularized to the specific 28 commodity markets covered in its rulemaking, but rather largely based on two case studies of market events: the 1979-1980 silver market crisis and the 2006 price volatility in the natural gas market.[10]

Which Contracts Will Be Subject to Speculative Position Limits?

The CFTC is proposing a phased approach for implementing position limits on physical commodity derivative contracts. In the first phase, the CFTC would establish position limits for 28 enumerated physical commodity futures contracts (19 agricultural , five metal and four energy) (Core Referenced Futures Contracts) and futures, options and swaps that are economically equivalent to those contracts (collectively Referenced Contracts).[11] To be considered economically equivalent to a Core Referenced Futures Contract, a contract must be directly or indirectly linked to either: a) the price of the particular core referenced futures contract or b) the price of the same commodity underlying the particular Core Referenced Futures Contract for delivery at the same location or locations as specified in that particular Core Referenced Futures Contract.[12]

The CFTC explains that it selected the 28 Core Referenced Futures Contracts, and related contracts, on the basis that such contracts "(i) have high levels of open interest and significant notional value of

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6 CEA Section 4a(a)(2); 7 U.S.C. § 6a(a)(2).

7 78 Fed. Reg. at 75682.

8 78 Fed. Reg. at 75682 (emphasis added). The CFTC primarily bases this interpretation on certain mandatory words in the statute and Dodd-Frank legislative history. *See* 78 Fed. Reg. at 75682-85.

9 78 Fed. Reg. at 75685.

10 *See* 78 Fed. Reg. at 75685-94.

11 78 Fed. Reg. at 75725. The term "Referenced Contract" would not include a guarantee of a swap, a basis contract, or a commodity index contract.

12 Proposed Rule 150.1 (definition of "referenced contract"). The CFTC's proposed positions limits also would apply to certain commodity derivatives contracts traded on a foreign board of trade (FBOT).

open interest or (ii) serve as a reference price for a significant number of cash market transactions." The CFTC notes that, in subsequent releases, it expects to expand the list of Core Referenced Futures Contracts in physical commodities.[13]

What Types of Position Limits Will the CFTC Impose on the Referenced Contracts?

The proposed rule would impose two basic types of speculative limits on positions in Referenced Contracts: spot-month limits and non-spot-month limits. Traders would have to comply with both types of limits on an intra-day basis.[14]

Spot-Month Position Limits

Spot-month limits are limits that apply during the trading period for a contract, not necessarily a month-long in duration, that immediately precedes the delivery period.[15] Physically delivered and cash-settled contracts (whether cash-settled futures or swaps) each would have their own spot-month limit set at the same level.[16] A trader would be permitted to net within each class of contracts (*i.e.*, physically delivered or cash-settled), but would not be able to net across physically delivered and cash-settled contracts for purposes of determining compliance with spot-month limits.[17]

The proposed spot-month limits for physically delivered and cash-settled contracts will be based on 25 percent of estimated deliverable supply for a Core Referenced Futures Contract in the same commodity.[18] However, in setting initial CFTC spot-month limits, the CFTC proposes to adopt the same spot-month limit levels that are currently in place at DCMs. Alternatively, initial CFTC spot-month limit levels may be based on estimates of deliverable supply submitted by a DCM, if verified by the CFTC. Subsequent levels would be adjusted at least every two years. These subsequent levels will be based on the CFTC's determination of deliverable supply (developed in consultation with DCMs).[19]

Non-Spot-Month Position Limits

Non-spot month position limits are limits that apply to all Referenced Contracts in a given commodity in all contract months combined including the spot month (*i.e.*, all- months-combined limits) or in a single month other than the spot month (*i.e.*, single-month limits). Single-month and all-months-combined non-spot-month limits would be set at the same level. A trader would be permitted to net futures/options positions against economically equivalent swaps for purposes of determining compliance with the non-spot-month limits.[20]

Unlike the spot-month limits, which would be a function of estimated deliverable supply, the non-spot-month limits would be based on an open-interest formula. Specifically, non-spot-month limits would be set at 10 percent of the open interest for all Referenced Contracts in a given commodity

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13 78 Fed. Reg. at 75725.

14 *See* 78 Fed. Reg. at 75768.

15 The spot month for cash-settled contracts generally would run from the start of the period in which the contract's settlement price is determined to the time when the price is determined and published. *See* Proposed Rule 150.1 (definition of "spot month").

16 78 Fed. Reg. 75724. Thus, if the spot-month limit for a Referenced Contract is 1,000 contracts, a trader could hold up to 1,000 contracts long in the physically delivered contract and up to 1,000 contracts long in the cash-settled contract.

17 78 Fed. Reg. at 75724.

18 78 Fed. Reg. at 75728.

19 78 Fed. Reg. at 75727.

20 78 Fed. Reg. at 75724.

(*i.e.*, aggregate futures, options and swaps open interest in a given commodity) for the first 25,000 contracts and 2.5 percent thereafter for any remaining open interest.[21] Proposed initial non-spot-month limit levels would be established by applying this 10/2.5 percent formula to open interest only in futures contracts, options thereon and swaps that are significant price discovery contracts.[22] Subsequent levels would be adjusted at least every two years and will be based on total average open interest for all Referenced Contracts in a commodity, using data reported by DCMs and SEFs.[23]

What Exemptions Will Be Available From the Position Limits?

The CFTC's proposed rules describe five categories of exemptions:

1. the bona fide hedging exemption;
2. the financial distress exemption;
3. the conditional spot-month limit exemption (only for cash-settled Referenced Contracts);
4. the pre-existing position exemption; and
5. requests for interpretive or exemptive relief from the CFTC.

Bona Fide Hedging Exemption

The CFTC's re-proposal codifies Dodd-Frank's amended definition of "bona fide hedging" for physical commodity derivatives. Unlike the vacated rules, the re-proposal defines bona fide hedging under one common provision for both physical and non-physical (*i.e.*, excluded) commodities.[24] As a result, the re-proposal deletes the existing bona fide hedging definition contained in Rule 1.3(z).[25]

The re-proposal provides three requirements for all bona fide hedges: (1) the hedge must be entered into to offset risks incidental to commercial cash, spot or forward market activities (the "incidental test"); (2) the hedge must be established and exited in an orderly manner to avoid as practicable the potential for significant market impact (the "orderly trading" requirement);[26] and (3) the hedge must be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise ("economic appropriateness" test).[27]

The definition recognizes two types of hedging: direct hedging of commercial activity and hedging of swaps that in turn hedge commercial activity.

Direct Hedging of Commercial Activity – Under the first type of bona fide hedging, a transaction or position in a physical commodity Referenced Contract that does not qualify as a "pass-through swap offset" (discussed below) must: (1) represent a substitute for subsequent transactions in the physical marketing channel ("temporary substitute" test); (2) arise from the potential change in the value of

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21 78 Fed. Reg. at 75729.

22 78 Fed. Reg. at 75730.

23 78 Fed. Reg. at 75734.

24 Proposed Rule 150.1 codifies all definitions specific to the Commission's expanded position limits regime, but does not number the definitions for administrative ease of making revisions in the future.

25 78 Fed. Reg. at 75706.

26 The re-proposal notes that the Commission intends to apply its recent "Interpretive Guidance and Policy Statement on Antidisruptive Practices Authority" in enforcing the orderly-trading requirement. See Proposed Rule at 75707 (citing 78 Fed. Reg. 31890 (May 28, 2013)).

27 Proposed Rule 150.1 ("bona fide hedging position" definition).

assets, liabilities, or services; and (3) qualify as one of several enumerated hedges (detailed below).[28] Notably, the temporary substitute test differs from the one finalized under the vacated rules in that it does not require the position to "normally" represent a substitute transaction and applies to bona fide pass-through swap offsets.[29]

The additional requirements for bona fide hedging positions in excluded commodities are the same as for physical commodities, except that the re-proposal does not impose the temporary substitute test. In a break from the vacated rules, however, the CFTC proposed to codify its 1987 risk management exemption interpretive statement as Appendix A to Part 150, upon which DCMs or SEFs would be permitted to base risk management exemptions for excluded commodities;[30] otherwise, the re-proposal requires that a bona fide hedge position in an excluded commodity qualify as one of the enumerated hedges.

Hedging of Swaps That in Turn Hedge Commercial Activity ("Pass- Through" Exemption) – The re-proposal treats pass-through swap offsets similarly to the vacated rules. Generally, a person who does not directly hedge commercial activity, such as a swap dealer, can establish a bona fide hedge (a "pass-through swap offset") against risks attendant to a swap if such swap (a "pass-through swap") would qualify as a bona fide hedge for the swap dealer's counterparty ("pass-through swap counterparty").[31] The exemption would cover the pass-through swap offset and the pass-through swap position to the extent that the position is offset.

The re-proposal suggests that the exemption should be necessary in only limited circumstances. The re-proposal would allow the swap dealer to net its pass-through swap positions with any positions that reduce the risk of the swap because netting is permitted across futures, options, direct-access linked foreign board of trade contracts, and economically equivalent swaps in the same Referenced Contract for purposes of single and all-months-combined positions limits. During the spot month, the swap dealer could net cash-settled pass-through swap positions with risk-reducing positions in cash-settled contracts, but not physically delivered contracts, given that netting is only permitted within classes for spot-month limit purposes. Therefore, a swap dealer may need the pass-through swap exemption during the spot month when — due to the restriction on netting across classes — the swap dealer would not be able to net cash-settled pass-through swaps against any risk-reducing physically-delivered positions.[32] The pass-through swap exemption also might be needed for a pass-through swap offset in a non-Referenced Contract in the same commodity underlying the pass-through swap.[33]

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28 Proposed Rule 150.1 ("bona fide hedging position" definition).

29 78 Fed. Reg. at 75708-09. The Commission noted that the temporary substitute test, as applied to pass-through swaps and pass-through swap offsets, is more stringent than it was when used previously for purposes of issuing risk management exemptions pursuant to Rules 1.3(z)(3) and 1.47.

30 78 Fed. Reg. at 75708 (citing 52 Fed. Reg. 34633 (Sep. 14, 1987)).

31 Proposed Rule 150.1(2)(ii) ("bona fide hedging position" definition)

32 *See* 78 Fed. Reg. at 75710.

33 As an example, assume that, during the spot month, a swap dealer enters into a pass-through swap opposite a bona fide hedger that results in a directional exposure of 100 long cash-settled swap positions in a Referenced Contract. The swap dealer then enters into 95 short physically delivered futures positions to reduce the risk of the pass-through swap. Due to the restriction on netting across classes in the spot month, the swap dealer would not be able to net its long cash-settled swap positions against its short physically delivered futures positions. Under the CFTC's bona fide hedging proposal, however, the swap dealer could claim an exemption for the 95 short physically delivered futures positions because they reduce the risk of the "pass through" swap and could claim an exemption for 95 long cash-settled swap positions of the "pass through" swap because that is the amount of the swap pass-through offset. The remaining five long swap positions would presumably be counted against the swap dealer's position limit.

Generally, the re-proposal would not recognize positions in physical delivery contracts as bona fide hedges during the lesser of the last five days of trading or the time period of the spot month for the physical-delivery contract ("five-day rule").[34] Notably, the re-proposal applies the five-day rule to pass-through swaps and swap offsets, which the vacated rules did not.[35]

Enumerated Hedge Positions – The re-proposal would make eight enumerated categories of hedging transactions eligible for the bona fide hedging exemption: (1) hedges of inventory and cash commodity purchase contracts; (2) hedges of cash commodity sales contracts; (3) hedges of unfilled anticipated requirements (including a new category for public utilities to hedge based on their customers' anticipated needs); 4) hedges by agents; (5) hedges of unsold anticipated production; (6) hedges of offsetting unfixed-price cash commodity sales and purchases; (7) hedges of anticipated royalties and (8) hedges of services.[36] Category 3 is not recognized under the five-day rule to the extent the hedge position in a physically-delivered contract exceeds unfilled anticipated requirements for the spot month and following month, whereas Categories 5-8 are not recognized at all under the five-day rule for physically-delivered contracts.

Like the vacated rules, the CFTC re-proposed a special procedure to petition the CFTC or its staff for an exemption pursuant to the CFTC's broad exemptive authority in CEA Section 4a(a)(7) or for an interpretive letter pursuant to Rule 140.99 for commonly-used hedge positions that are not otherwise enumerated under the bona fide hedging definition.[37] The re-proposal provides little detail as to what factors will be considered in granting an exemption or interpretive letter.

Unlike the vacated rules, the CFTC did not re-propose unfilled storage capacity as an anticipated merchandizing hedge. The CFTC instead reverted to its historical view that merchandizing transactions generally fail to meet the economically appropriate test, citing additional market data it considered that showed low correlation between calendar month value spreads and value fluctuations in expected rental returns a merchandizer could expect to receive from storage facilities.[38] Additionally, the CFTC explicitly declined to recognize as bona fide six out of ten specific types of hedges that the Working Group of Commercial Energy Firms (Working Group) petitioned the CFTC to recognize under the vacated rules.[39]

Cross-Commodity Hedging – The re-proposal allows for all enumerated hedges and pass-through swap offsets to be used to hedge price risk arising from a commodity other than the specific one underlying the hedge position, so long as the commodities are "substantially related" to one another and subject to the five-day rule. Qualitatively, a reasonable commercial relationship must exist (such

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34 78 Fed. Reg. at 75710.

35 *See* 78 Fed. Reg. at 75710, n. 305. The Commission changed its policy after studying data for physical-delivery energy contracts and observing that traders rarely used physical delivery contracts to hedge risks arising from swaps during the physical delivery spot month.

36 Proposed Rule 150.1(3)-(4). Appendix C to the re-proposal includes fact patterns and analyses to illustrate the enumerated hedging transactions.

37 78 Fed. Reg. at 75738.

38 *See* 78 Fed. Reg. at 75718.

39 *See* 78 Fed. Reg. at 75719-23. The positions rejected by the CFTC were: 1) positions used to lock in a price differential where one leg of the cash transaction is an un-priced commitment to buy or sell a physical commodity, and the offsetting sale or purchase has not been completed; 2) positions used to hedge exposure to market price volatility associated with binding and irrevocable fixed-price bids or offers; 3) positions used to hedge a physical transaction that is subject to ongoing, good-faith negotiations and that the hedging party reasonably expects to conclude; 4) short positions used to hedge a calendar month average price purchase of crude oil from a producer, and long positions to hedge risks attendant with anticipated resale of crude oil at the calendar month average price; 5) cross-commodity hedges using a physical-delivery contract carried into the spot month and 6) cross-commodity hedges using a physical-delivery contract to meet unfilled anticipated requirements. The Working Group is a coalition of commercial end-user firms in the energy industry whose primary business activity is the physical delivery of energy commodities to commercial and residential consumers.

as between milo and corn, both used as food grain for humans).[40] Quantitatively, while no particular methodology is prescribed, there must be at least a .8 correlation over 36 months between first differences or returns in daily spot prices between the two commodities.[41]

Procedural Requirements for Bona Fide Hedging Exemptions – The re-proposal would require all bona fide hedges to be reported pursuant to revised Part 19, which has been simplified to clarify that reporting requirements apply to all commodity derivative contract positions (including swaps) that exceed speculative positions limits.[42] In addition to filing revised Forms 204 and 304 for physical commodity positions (including cross-commodity hedges), all traders intending to rely upon the enumerated anticipatory hedging exemptions for unfilled requirements, unsold production, royalties, services contract payments or receipts, and cross-commodity hedges would be required to file new Form 704 at least 10 days in advance of the date when the respective position limit is expected to be exceeded.[43] The form must be updated annually and on an ongoing basis to reflect actual utilization of the anticipatory bona fide hedging exemption claimed. Additionally, the re-proposal would require traders relying on the swap pass-through offset exemption to file new Form 604, which provides information on the position(s) being hedged and why the hedge position is needed.[44]

Financial Distress Exemption

Financial distress circumstances are situations involving the potential default or bankruptcy of a customer, an affiliate, or a potential acquisition target of the person requesting the exemption. Persons seeking to rely on this exemption must make a request to the CFTC, and any exemptions would be granted by CFTC order.[45]

Conditional Spot-Month Limit Exemption

The conditional spot-month limit exemption would allow cash-settled Referenced Contract positions to exceed the spot-month limit specified by the CFTC by up to five times the level of such limit, provided that the person holding or controlling such cash-settled positions: 1) does not hold or control positions in the spot-month physical delivery Referenced Contracts and 2) files a new Form 504 every day that the person exceeds the relevant spot-month limit if the cash-settled positions are in natural gas.[46]

The CFTC also has proposed alternatives to the conditional spot-month limit exemption. Under one alternative, a person could only claim the exemption for positions in cash-settled contracts that settle to an index based on cash-market transaction prices. Under a second alternative, a person could claim the exemption for cash-settled contracts that settle to an index based on cash-market transaction prices but also would be able to hold cash-settled contracts that settle to the underlying physical delivery contract up to the spot-month limit level of the underlying physical-delivery contract, with an

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40 78 Fed. Reg. at 75716. The re-proposal suggests that a reasonable commercial relationship does not exist between a physical commodity and a stock price index.

41 78 Fed. Reg. at 75717. The re-proposal notes that electricity and natural gas would not be sufficiently correlated.

42 *See* 78 Fed. Reg. at 75742.

43 Proposed Rule 150.7.

44 *See* 78 Fed. Reg. at 75744-45.

45 78 Fed. Reg. at 75786.

46 The CFTC claims that this proposed exemption would satisfy the statutory goals of CEA Section 4a(a)(3) by: 1) eliminating all speculation in the physical delivery contract during the spot month by a trader availing herself of the conditional spot-month limits exemption; 2) ensuring sufficient market liquidity in the cash-settled contact for bona fide hedgers; and 3) protecting the price discovery process in the physical delivery contract from the risk that traders with an expanded position in cash-settled contracts would otherwise attempt to mark the close or distort physical delivery prices to benefit their expanded cash-settled position. 78 Fed. Reg. at 75737.

aggregate limit of five times the spot-month limit level applying to all types of cash-settled contracts. Finally, under a third alternative, the CFTC proposes to eliminate the prohibition on holding positions in a spot-month physical delivery contract so a trader could claim the exemption and simultaneously hold such physical delivery positions.[47]

Pre-existing Position Exemption

The CFTC would allow positions in Referenced Contracts to exceed non-spot-month limits to the extent that the positions were entered into in good faith prior to the effective date of the CFTC's new non-spot-month limits. If a trader's preexisting positions are below the limit, the trader would be able to increase her positions, but the combined pre-existing and new positions would be counted against the limit.[48]

Swap positions entered into in good faith prior to the effective date of CFTC-set initial limits would be exempt from both the spot-month and non-spot-month limits, with netting of pre-effective date swap positions against post-effective date commodity derivative contracts allowed in complying with any non-spot-month position limit.[49]

Recordkeeping Requirements for Position Limit Exemptions – In addition to the reporting requirements under revised Part 19 noted above, the proposed rules set forth recordkeeping requirements for claiming and maintaining several of the exemptions to speculative position limits. Generally, any person who claims an exemption to a speculative position limit would be required to keep and maintain complete books and records concerning all details of the person's related cash, forward, futures, options, and swap positions and transactions, the details of which would be reflected on the various series '04 reports required by revised Part 19.

How Will Positions Be Aggregated for Purposes of Determining Compliance With Position Limits?

Under the proposed aggregation rules, there would be four bases for requiring a trader to aggregate his own positions with the positions of another person or entity: (1) control, (2) ownership or equity interest, (3) trading pursuant to an express or implied agreement or (4) substantially identical trading.

Control

Consistent with the CFTC's existing aggregation requirement,[50] any person or entity that controls, directly or indirectly, a position in commodity derivative contracts, an account with a position, or another person who has a position or an account, would be required to aggregate 100 percent of those positions or accounts. Neither the existing nor the proposed aggregation rules provide a definition of "control."

Ownership or Equity Interest

Consistent with the existing aggregation requirement, any person that directly or indirectly holds a 10 percent or greater ownership or equity interest in a position or account (an owned position), or that directly or indirectly holds a 10 percent or greater ownership or equity interest in any entity that owns or controls a position or account (an owned entity), would be required to aggregate 100 percent of all

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47 78 Fed. Reg. at 75738.

48 78 Fed. Reg. at 75734.

49 78 Fed. Reg. at 75738.

50 *See* 17 C.F.R. § 150.4.

such positions. The proposal provides a variety of exemptions from aggregation based on ownership or equity interest (discussed below).

Trading Pursuant to an Express or Implied Agreement

Consistent with the existing aggregation requirement, any two or more persons, each of whom controls positions or accounts or has owned positions, owned accounts or owned entities, who act pursuant to an express or implied agreement or understanding would be treated as if their positions were traded or controlled by a single person.

Substantially Identical Trading

The proposed aggregation rules would introduce a new basis for aggregation — substantially identical trading. Any person that holds positions in or controls the trading of commodity derivative contracts in more than one account or commodity pool[51] with substantially identical trading strategies would be required to aggregate 100 percent of the positions in such accounts or pools. The proposal contains no discussion of the "substantially identical" concept or any justification for requiring aggregation on the basis of "substantially identical trading."

What Exceptions and Exemptions Are Available for the Aggregation Requirement?

There would be eight possible bases for exemption or exception from the proposed aggregation requirements.

Pool Participant Exemption

Consistent with the existing exemption for investors in pools,[52] any limited partner, shareholder or similar type of pool participant that, directly or indirectly, has a 10 percent or greater ownership or equity interest in a pool does not need to aggregate any of the positions or accounts of the pool, unless:

1. The pool participant is the commodity pool operator (CPO) of the pool;
2. The pool participant is a principal or affiliate of the CPO of the pool, unless the participant can demonstrate to the CFTC that it has no knowledge of the day-to-day trading of the pool; or
3. The pool participant has a 25 percent or greater ownership or equity interest in a pool whose CPO is exempt from registration under CFTC Rule 4.13.

Unlike the existing exemption for pool participants, a principal or affiliate of a CPO that can make the demonstration in paragraph 2) above would be required to file a notice with the CFTC in order to be eligible for the pool participant exemption.

Owned Entity Exemption (Under 50 Percent Ownership Interest)

The proposed aggregation rules would provide an exemption from aggregation to a person (an "owner") with an ownership or equity interest in an owned entity that exceeds 10perent but that is not more than 50 percent. This owned entity exemption (under 50 percent) would require that the owned entity, each owner and each person whose positions the owner must aggregate:

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51 The term "commodity pool" or "pool" means any investment trust, syndicate or similar form of enterprise operated for the purpose of trading in commodity interests. CEA Section 1a(10).

52 *See* 17 C.F.R. § 150.4(c).

1. Does not have knowledge of the trading decisions of the other(s);
2. Trades pursuant to separately developed and independent trading systems;
3. Has and enforces written procedures to preclude each from having knowledge of gaining access to, or receiving data about, trades of the other(s);
4. Does not share employees who control trading decisions; and
5. Does not have risk management systems that permit sharing of trade or trading strategies

Persons would be required to file a notice with the CFTC in order to be eligible for the owned entity exemption.

Owned Entity Exemption (More Than 50 Percent Ownership Interest)

The proposed aggregation rules would provide an exemption from aggregation to an owner with an ownership or equity interest in an owned entity that exceeds 50 percent. The owned entity exemption (over 50 percent) would need to be applied for and would be granted at the CFTC's sole discretion; the preamble explained that there would be no time limit imposed on the CFTC's process for approval.[53]

This owned entity exemption (more than 50 percent) would require:

1. certification to the CFTC that the owned entity's financial results are not required under U.S. GAAP to be consolidated with the financial statements of the owner;
2. that each of the owner, each person whose positions the owner would aggregate and the owned entity meets the requirements of the owned entity exemption (under 50 percent) and the owner demonstrates to the CFTC that procedures are in place to prevent coordinated trading decisions between such entities;
3. that any director of the owned entity (or equivalent governing persons) who is the representative of the owner certifies to the CFTC that he does not control the trading decisions of the owned entity;
4. certification to the CFTC that either all of the owned entity's positions qualify as "bona fide hedging positions" or that none of the owned entity's positions exceed 20 percent of any position limit in effect;[54]
5. that the owned entity respond to calls from the CFTC concerning the owned entity's "positions and transactions" (without regard to whether the owned entity is subject to the recordkeeping provisions of the CFTC's large trader reporting rules); and
6. that the CFTC will be notified (and provided with any CFTC-requested information) if an owned entity coordinates its trading with the owner or any person whose positions the owner must aggregate.

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53 78 Fed. Reg. at 68960.

54 If this certification becomes untrue, the owner must aggregate the owned entity's positions and accounts for a three-month period, and if all of the owned entity's positions during the three-month period qualify as bona fide hedging positions, the owner would have the opportunity to make the certification again in order to once again stop aggregating the owned entity's positions and accounts.

Independent Account Controller Exemption

The proposed aggregation rules would keep the CFTC's longstanding independent account controller exemption, but would impose additional conditions that would narrow its availability (IAC Exemption). The IAC Exemption would exempt an "eligible entity"[55] from aggregating its clients' positions or accounts as long as those client positions or accounts are carried by an IAC and as long as the overall positions held or controlled by such IAC do not exceed the CFTC's position limits.[56]

If the IAC is affiliated with the eligible entity (or with another IAC), the Proposed Aggregation Rules would require each such affiliated entity to:

1. Have and enforce written procedures to preclude the affiliated entities from having knowledge of, gaining access to, or receiving data about trades of the other;
2. Trade such accounts pursuant to separately developed and independent trading systems;
3. Market such trading systems separately; and
4. Solicit funds for such trading by separate disclosure documents that meet the CFTC's requirements for disclosure documents, if such documents are required by the CFTC's rules.

The IAC Exemption would not be available for spot month positions. Like most of the other proposed exemptions, a person would be required to file a notice with the CFTC to be eligible for the exemption.

Information Sharing Restriction Exemption

The proposed aggregation rules also would provide owners with an exemption from aggregating the positions and accounts of an owned entity if the sharing of information associated with such aggregation would create a reasonable risk that either the owner or the owned entity would violate state or federal law or the law of a foreign jurisdiction, or any regulations adopted thereunder (Information Sharing Restriction Exemption). As a condition of the Information Sharing Restriction Exemption, the owner could not have actual knowledge of the owned entity's positions.

Owners who satisfy the conditions for the Information Sharing Restriction Exemption would be required to file a notice with the CFTC and attach to the notice a memorandum of law explaining in detail the basis for the conclusion that the sharing of information creates a reasonable risk of either the owner or the owned entity violating state, federal or foreign law information-sharing restriction.

Exemption for Broker-Dealers, Underwriting and Futures Commission Merchants

The Proposed Aggregation Rules would keep the existing exemption for futures commission merchants (FCMs) (with respect to the clients' accounts in which they do not control trading) and would add exemptions for underwriters (who become "owners" of an "owned entity" because they have an allotment of securities from an offering) and for broker-dealers, registered either with the Securities and Exchange Commission or a foreign jurisdiction (who become "owners" of less than 50 percent of an "owned entity" through securities acquired in the normal course of its broker-dealer business). If adopted as proposed, FCMs would be required to file a notice with the CFTC in order to be eligible for the exemption.

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55 The term "eligible entity" is currently defined in Rule 150.1(d). 17 C.F.R. § 150.1(d). The proposed aggregation rules would amend the existing definition by adding a reference to "limited members" in addition to "limited partner or shareholder in a commodity pool." *See* 78 Fed. Reg. at 68976.

56 The term "independent account controller" is currently defined in Rule 150.1(e). 17 C.F.R. § 150.1(e). The proposed aggregation rules would revise the current definition to clarify that the IAC's fiduciary duty is "to the managed positions and accounts" and that an IAC could be a "general partner, managing member or manager of a [pool] the operator of which is excluded from registration under [Rule] 4.5(a)(4) or [Rule 4.13]." *See* 78 Fed. Reg. at 68976.

Higher-Tier Entities

The Proposed Aggregation Rules also would allow the owner of an owned entity to rely on any exemptions from aggregation that have been claimed by that owned entity, including the IAC Exemption. For example, if A owns B, and B owns C, and B has claimed the IAC Exemption with respect to C, A would not need to find its own exemption from aggregation with respect to C; A could simply rely on the exemption that B has claimed. Any higher-tier entity seeking to rely on an exemption claimed by an owned entity would be required to comply with the conditions of such exemption (except for filing the notice with the CFTC) and could not otherwise control the trading of positions or accounts identified in the owned entity's notice.

How Would the Proposed Rules Affect Designated Contract Market and Swap Execution Facility Position Limits and Position Accountability Levels?

The CFTC has proposed requirements and acceptable practices for DCMs and SEFs to follow in establishing position limits and position accountability levels on contracts executed on their markets.

DCM and SEF Position Limits on Referenced Contracts

For Referenced Contracts, DCMs and SEFs would be required to impose spot-month and non-spot-month limits at levels no greater than the corresponding CFTC limit. A DCM or SEF would continue to be free to enforce position limits that are more stringent than the CFTC limits.[57]

DCM and SEF Position Limits on Contracts That Are Not Referenced Contracts

For contracts that are not Referenced Contracts (Non-Referenced Contracts), the CFTC would establish "acceptable practices" for DCMs and SEFs to set spot-month and non-spot-month limits. Acceptable practices would not be requirements, but rather strongly encouraged means of complying with statutory core principle obligations of DCMs and SEFs.[58] The CFTC's proposed acceptable practices are:[59]

- Spot-month limits:
  - For a Non-Referenced Contract based on a commodity with a measurable deliverable supply, a DCM or SEF should use the CFTC's 25 percent estimated deliverable supply formula to set the spot-month limit.
  - For a Non-Referenced Contract based on a commodity *without* a measurable deliverable supply, a DCM or SEF should set a spot-month limit at a level no greater than necessary and appropriate to reduce the potential threat of market manipulation or price distortion of the contract's or the underlying commodity's price.
  - For a Non-Referenced Contract that is cash-settled by referencing the daily settlement price of an existing contract listed on a DCM or SEF, the same spot-month limit level that applies to that existing contract should be used for the cash-settled contract.
- Non-spot-month limits:
  - For an initially listed (*i.e.*, new) Non-Referenced Contract based on an agricultural commodity, a DCM or SEF generally should set single-month and all-months-combined limits at a level no greater than 1,000 contracts.

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57 78 Fed. Reg. at 75755-56.

58 The DCM and SEF statutory core principles relevant to position limits are DCM Core Principle 5 and SEF Core Principle 6.

59 78 Fed. Reg. at 75757-58.

  - For an initially listed Non-Referenced Contract based on an exempt commodity (*i.e.*, energy or metal commodity) or an excluded commodity, a DCM or SEF generally should set single-month and all-months-combined limits at a level no greater than 5,000 contracts.
  - For a Non-Referenced Contract that is cash-settled by referencing a daily settlement price of an existing contract listed on a DCM or SEF, the same single-month and all-months-combined limits for that existing contract should be used for the cash-settled contract.
  - In adjusting non-spot-month limits, a DCM or SEF should ensure that limit levels are no greater than 10 percent of the average combined futures and option month-end open interest for the most recent calendar year up to 25,000 contracts, with a marginal increase of 2.5 percent of the remaining open interest thereafter.
- Both spot-month and non-spot-month limits:
  - A DCM or SEF should review all limit levels no less than once every two years.

DCM and SEF Position Accountability Levels for Certain Non-Referenced Contracts

Under the CFTC's proposal, DCMs and SEFs may adopt position accountability levels in lieu of position limits in the spot month for the following Non-Referenced Contracts: 1) excluded commodity derivative contracts with a highly liquid cash market and no legal impediment to delivery, and 2) excluded commodity derivative contracts without a measurable deliverable supply. DCMs and SEFs may impose position accountability levels in lieu of position limits outside the spot month for the following Non-Referenced Contracts: 1) contracts on agricultural and exempt commodities (outside of the 28 specified in the CFTC's final rules) that meet certain open interest, volume and liquidity thresholds, and 2) excluded commodity derivative contracts. In addition, if a new Non-Referenced Contract that is listed for trading on a DCM or SEF is substantially the same as an existing DCM or SEF contract that is subject to position accountability levels, then the DCM or SEF may adopt those position accountability levels for the new Non-Referenced Contract. If a trader exceeds a position accountability level, the trader would be required, upon request by the DCM or SEF, to provide information about the trader's position and to consent to halt increasing further the trader's position or to reduce the trader's position in an orderly manner.[60]

Aggregation Provisions and Bona Fide Hedging and Other Exemptions for DCM and SEF Position Limit and Position Accountability Regimes

The CFTC's proposed rules also would require DCMs and SEFs to apply position aggregation standards and position limit exemptions that mirror the CFTC's requirements.[61] Traders would be required to apply to the DCM or SEF for any exemptions from the DCM or SEF's speculative position limits.[62]

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60 78 Fed. Reg. at 75758.

61 DCMs and SEFs also could grant exemptions for intramarket and intermarket spread positions provided that certain conditions are met. In addition, the CFTC would continue to allow a DCM or SEF to grant a limited "risk management" exemption for excluded commodity derivative contracts.

62 78 Fed. Reg. at 75754.

(Table 1 appears on the next page.)

Table 1

Core Referenced Futures Contract	Proposed Spot-Month Limits (Applied separately to cash-settled contract positions and physical delivery contract positions.)	Proposed Single-Month and All-Months Limits (Applied to futures equivalent of net futures, options, and swaps positions.)
LEGACY AGRICULTURAL		
CBOT Corn (C)	600	53,500
CBOT Oats (O)	600	1,600
CBOT Soybeans (S)	600	26,900
CBOT Soybean Meal (SM)	720	9,000
CBOT Soybean Oil (SO)	540	11,900
CBOT Wheat (W)	600	16,200
ICE Futures U.S. Cotton No. 2 (CT)	300	8,800
KCBT Hard Winter Wheat (KW)	600	6,500
MGEX Hard Red Spring Wheat (MWE)	600	3,300
OTHER AGRICULTURAL		
CBOT Rough Rice (RR)	600	2,200
CME Class III Milk (DA)	1500	3,400
CME Feeder Cattle (FC)	300	3,000
CME Lean Hog (LH)	950	9,400
CME Live Cattle (LC)	450	12,900
ICE Futures U.S. Cocoa (CC)	1,000	7,100
ICE Futures U.S. Coffee C (KC)	500	7,100
ICE Futures U.S. FCOJ-A (OJ)	300	2,900
ICE Futures U.S. Sugar No. 11 (SB)	5,000	23,500
ICE Futures U.S. Sugar No. 16 (SF)	1,000	1,200
ENERGY		
NYMEX Henry Hub Natural Gas (NG)	1,000	149,600
NYMEX Light Sweet Crude Oil (CL)	3,000	109,200
NYMEX NY Harbor Ultra Low Sulfur Diesel (ULSD) (HO)	1,000	16,100
NYMEX RBOB Gasoline (RB)	1,000	11,800
METALS		
COMEX Copper (HG)	1,200	5,600
COMEX Gold (GC)	3,000	21,500
COMEX Silver (SI)	1,500	6,400
NYMEX Palladium (PA)	650	5,000
NYMEX Platinum (PL)	500	5,000