

CFTC Issues Final Regulations on Position Limits for Futures and Swaps

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On October 18, the Commodity Futures Trading Commission (CFTC) issued a Final Rule codifying regulations that establish limits on speculative positions in 28 physical commodity futures contracts traded pursuant to the rules of a Designated Contract Market (DCM)¹ and economically equivalent swaps. The CFTC's Final Rule implements Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), which directed the CFTC to issue a rule limiting the amount of positions, other than bona fide hedging positions, that may be held by any person in connection with commodity futures and option contracts traded pursuant to the rules of a DCM.

Presently, the CFTC does not regulate position limits for energy commodities. Through the enactment of the Dodd-Frank Act, however, the CFTC was directed to develop a multitude of regulations through its rulemaking process for the purpose of establishing a regulatory regime applicable to the U.S. financial markets within the CFTC's jurisdiction, including the U.S. swap market. The CFTC has identified 30 areas requiring the issuance of rules, including an area relating to the establishment of position limits. As such, the CFTC's Final Rule represents another component of the CFTC's expanding regulatory authority with respect to swaps, futures, and option contracts.

With respect to energy commodity contracts, the CFTC's Final Rule addresses four referenced contracts:

- New York Mercantile Exchange Light Sweet Crude Oil
- New York Mercantile Exchange New York Harbor No. 2 Heating Oil
- New York Mercantile Exchange New York Harbor Gasoline Blendstock
- New York Mercantile Exchange Henry Hub Natural Gas

The Final Rule sets forth two types of position limits subject to regulation: spot-month position limits and non-spot-month position limits.

Spot-month position limits apply in the period immediately before delivery obligations are incurred for physical delivery contracts or immediately before contracts are liquidated by the clearinghouse based on a reference price for cash-settled contracts. Limits will generally be set at 25% of estimated "deliverable supply" and mark the maximum combined position a trader can hold in the physical delivery or in cash-

1. These commodities include nine "legacy" agricultural contracts, ten non-"legacy" agricultural contracts, four energy contracts, and five metal contracts.

settled referenced contracts. Presently, it is uncertain precisely how the CFTC intends to define “deliverable supply.” However, if the CFTC adheres to its description of “deliverable supply” set forth in the Notice of Proposed Rulemaking (NOPR) that preceded the issuance of the Final Rule, then “deliverable supply” would refer to the quantity of the commodity meeting a derivative contract’s delivery specifications that can reasonably be expected to be readily available to short traders and saleable by long traders at its market value.

Notably, the CFTC specifically determined to exempt cash-settled New York Mercantile Exchange Henry Hub Natural Gas contracts from the limit described above. Instead, such cash-settled contracts will be subject to a cash-settled spot-month position limit and an aggregate limit that extends across positions in both physical delivery and cash-settled natural gas contracts. Cash-settled and aggregate positions will both be set at five times the limit that applies to the physical-delivery New York Mercantile Exchange Henry Hub Natural Gas contract. The regulations regarding spot-month limits will become effective 60 days after the term “swap” is further defined.²

With respect to non-spot-month position limits, the Final Rule provides that such limits are determined by open interest³ instead of deliverable supply. They will be set at 10% of open interest in the first 25,000 contracts and 2.5% afterwards. The CFTC will generally set these limits using one year of open interest data and biennially from then on.

The Final Rule also contains a bona fide hedge exemption for energy traders hedging inventory holdings of the underlying physical commodity or anticipatory trades in the physical commodity. This exemption was broadened from that proposed in the CFTC’s NOPR by including certain anticipated merchandising transactions, royalties, and service contracts. Positions that were established in good faith before the initial limits become effective are also exempted.

The CFTC’s current position limits aggregation policy is incorporated in the Final Rule. This policy applies limits to all positions in which one person holds an ownership interest of 10% or more.⁴ The final regulations also recognize the CFTC’s independent account controller exemption that exempts traders in commodity pools who have ownership or equity interests of less than 25% unless the trader controls the trading done by the pool.

Additionally, the Final Rule establishes a position visibility reporting regime to provide the CFTC with better information on the positions of large traders in the markets. Quarterly position visibility reporting requirements are imposed on traders exceeding a non-spot-month position visibility level in energy- and metal-referenced contracts. These reports will provide information about the physical and swaps portfolios of the largest traders and about the trading activity in the physical commodity futures and swaps markets. They will enable the CFTC to make future adjustments to the position limit framework.

2. The CFTC also voted to propose delaying until July 16, 2012 the deadline for issuing many rules that the CFTC is developing in response to the Dodd-Frank Act. In that regard, the CFTC’s definition of “swap” and, therefore, the effective date of the CFTC’s Final Rule may not take effect for nine more months.

3. Open interest is the sum of futures open interest, cleared swaps open interest, and uncleared swaps open interest.

4. This includes positions held by two or more persons acting pursuant to any agreement or understanding.

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