THE CFTC ONCE AGAIN PROPOSES POSITION LIMITS FOR ENERGY DERIVATIVES RELATED TO OIL, GAS AND REFINED PRODUCTS

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U.S. Investment Management Alert

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INTRODUCTION

On January 30, 2020, the Commodity Futures Trading Commission ("CFTC" or "Commission") approved a proposed rule (the "Proposed Rule") for new and amended regulations concerning speculative position limits for derivatives. [1] For nearly a decade, the CFTC has proposed, amended, and re-proposed position limit rules and aggregation standards for speculative positions in certain physical commodity contracts and their economic equivalents. [2] Critically, the Proposed Rule would create new or modify existing federal limits for 25 physical commodity derivatives and economically similar contracts [3] and it would revise the definition of "bona fide hedging transactions or positions." The Proposed Rule reflects the CFTC's latest attempt to reconcile the derivatives markets' need for bona fide hedging with its mandate to protect markets and their users from purely speculative financial activity that could adversely impact commodity pricing. [4]

The Proposed Rule was published in the *Federal Register* on February 27, 2020, and comments are due by April 29, 2020. [5] Market participants and commodity exchanges must comply with the Proposed Rule's requirements no later than one year after publication of the final rule in the *Federal Register*.

The Proposed Rule has four primary components:

1. New and amended federal spot month limits for 25 physical commodity derivatives and physically settled and linked cash-settled futures, options on futures, and economically equivalent swaps tied to such commodities;
2. Exemptions from position limits, such as a revised definition of "bona fide hedging transactions or positions," and an expanded list of enumerated bona fide hedges to cover additional hedging practices;
3. A streamlined bona fide hedge exemption request process for both exchange-set and federal position limit requirements; and
4. Elimination of certain duplicative reporting requirements for information currently available to the Commission via the exchanges.

PRACTICAL IMPLICATIONS

- If the Proposed Rule is implemented, position limits will become effective for metals and energy products. For the first time, traders, asset managers, and commercial end users of those products would be

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required to assess how federal position limits may impact their business operations. Market participants should be aware that while the Proposed Rule is generally consistent with the European Union's ("EU") position limits requirements, there are some key differences that could impact market participants operating in the global derivatives market. [6]

- While the Proposed Rule would capture additional derivatives contracts, the CFTC would increase the number of exceptions from its federal position limits, as well as expand the scope of its existing exceptions. In addition, the CFTC proposed to amend the definition of "bona fide hedging position or transaction." As a result, the Proposed Rule would result in some market participants now becoming subject to the CFTC's federal position limits, with other market participants potentially being exempted from the Proposed Rule's more onerous requirements. In addition, all market participants must review their current policies and procedures to ensure they are up to date.
- The new streamlined process for non-enumerated bona fide hedge exemptions will likely be welcomed by market participants. For market participants hoping to use innovative methods to hedge derivatives and underlying commodity risks, this portion of the Proposed Rule should ensure market participants are not confined to only use exemptions enumerated by the CFTC.
- Market participants must also apply the CFTC's existing rules on aggregation when determining the potential impact of the Proposed Rule on their business. [7] Unless the CFTC offers additional no-action relief, the CFTC's aggregation requirements may affect market participants who otherwise might not be subject to federal position limit requirements.

CONTRACTS SUBJECT TO THE PROPOSED FEDERAL SPECULATIVE POSITION LIMITS

For ease of reference, this Alert contains an Appendix A, which provides charts summarizing the 25 physically settled futures contracts covered by the Proposed Rule.

The Proposed Rule would apply federal position limits to a universe of 25 physically settled Core Referenced Futures Contracts ("CRFCs") and their linked cash-settled futures, options on futures, and "economically equivalent" swaps (collectively, "Referenced Contracts"). All 25 CRFCs are listed in the table in Appendix A, and a brief summary of the Proposed Rules updates to CRFCs follows:

- Nine of the 25 CRFCs are currently subject to federal position limits (the "Legacy Contracts");
- Sixteen CRFCs would be newly subject to federal position limits, including seven additional agricultural contracts;
- Four of the new CRFCs are energy contracts; and
- Five of the new CRFCs are metals contracts.

In addition, the Proposed Rule would subject any "economically equivalent swap" to federal position limits. An "economically equivalent swap" would include any swaps with "identical material" contractual specifications, terms, and conditions to a referenced contract, but disregards any differences due to (1) notional amount or lot size, (2) post-trade risk management arrangements, or (3) for physically settled swaps, delivery dates diverging

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by less than one calendar day. [8] Additionally, a market participant would generally no longer be allowed to treat a position or transaction as a bona fide hedge simply because it was entered into for "risk management purposes." [9] This potential modification may significantly alter how swap dealers, asset managers, and other financial intermediaries utilize derivative contracts to mitigate their risks.

The Proposed Rule would apply federal spot month limits to Referenced Contracts on all 25 CRFCs. [10] The proposed spot month limit levels, summarized in the table in Appendix A, are set at or below 25 percent of deliverable supply based on designated contract market estimates of available deliverable supply. [11] The proposed spot month limits would apply on a futures-equivalent basis based on the size of the unit of trading of the relevant core referenced futures contract and would apply "separately" to physically settled and cash-settled Referenced Contracts.

The Proposed Rule would also allow a market participant to net positions across physically settled Referenced Contracts and separately net positions across cash-settled Referenced Contracts. However, a market participant would not be permitted to net cash-settled Referenced Contracts against physically settled Referenced Contracts.

EXEMPTIONS FROM FEDERAL POSITION LIMITS

The Proposed Rule updates the current exemptions from the federal position limits by categorizing exemptions for (1) bona fide hedging transactions and positions, (2) spread positions, [12] (3) certain financial distress positions, [13] (4) certain natural gas positions held during the spot month, and (5) pre-enactment and transition period swaps. [14]

BONA FIDE HEDGES

The Proposed Rule provides a broader exemption for bona fide hedging than current regulations. Notably, the Proposed Rule would amend the definition of "bona fide hedging positon or transaction" to be broad enough to "accommodate common commercial hedging practices, including anticipatory hedging practices such as anticipatory merchandising." [15] Under the Proposed Rule, a position or transaction is considered to be engaged in for bona fide hedging purposes and, therefore, exempt from federal position limit requirements if the following elements are satisfied:

5. the hedge represents a substitute for transactions or positions made at a later time in a physical marketing channel ("temporary substitute test");
6. the hedge is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise ("economically appropriate test"); and
7. the hedge arises from the potential change in value of actual or anticipated assets, liabilities, or services ("change in value requirement").

The Proposed Rule would also expand the list of enumerated bona fide hedges by including additional hedging practices such as anticipatory merchandising. In addition, market participants would no longer need to file Form 204 with the CFTC on a monthly basis to demonstrate cash-market positions justifying position limit overages. Instead, the CFTC would obtain access to cash-market information submitted by market participants when they file their applications to exchanges for exemptions from exchange-set limits.

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Market participants must carefully consider the new definition of “bona fide hedging” and determine whether their current hedging practices need to be modified. Accordingly, market participants should review their risk management process and consider whether they need to update their current practices, policies, or procedures.

A STREAMLINED PROCESS FOR NON-ENUMERATED BONA FIDE HEDGES

In addition, the Proposed Rule would allow market participants to provide a single application to an exchange to request a non-enumerated bona fide hedge exemption. So long as the CFTC does not object within the review period of 10 business days (or two business days in the case of sudden or unforeseen bona fide hedging needs) and the exchange approves of the bona fide hedge, the applicant will receive approval from both the CFTC and the exchange's requirements.

LOOKING AHEAD

After the long and winding path for the position limits requirements, the Proposed Rule is the latest step by the CFTC to end the position limits saga. While market participants should carefully monitor developments relating to the Proposed Rule, it is also crucial to focus on how individual exchanges amend their own position limits and related requirements in response to the Proposed Rule. K&L Gates' futures and derivatives team looks forward to assisting market participants navigate these developments, the evolving global regulation of derivatives, and recent and proposed changes by U.S. regulators with respect to derivatives and similar instruments. [16]

APPENDIX A – SPECULATIVE POSITION LIMIT LEVELS

Legacy Agricultural

Contract	Spot Month	Single-Month and All Months
Chicago Board of Trade Corn (C)	1,200	57,800
Chicago Board of Trade Oats (O)	600	2,000
Chicago Board of Trade Soybeans (S)	1,200	27,300
Chicago Board of Trade Soybean Meal (SM)	1,500	16,900
Chicago Board of Trade Soybean Oil (SO)	1,100	17,400
Chicago Board of Trade Wheat (W)	1,200	19,300
Chicago Board of Trade	1,200	12,000

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KC HRW Wheat (KW)		
Minneapolis Grain Exchange Hard Red Spring Wheat (MWE)	1,200	12,000
ICE Futures U.S. Cotton No. 2 (CT)	1,800	11,900

Other Agricultural

Contract	Spot Month	Single-Month and All Months
Chicago Board of Trade Rough Rice (RR)	800	Not Applicable
Chicago Mercantile Exchange Live Cattle (LC)	600/300/200	Not Applicable
ICE Futures U.S. Cocoa (CC)	4,900	Not Applicable
ICE Futures U.S. Coffee C (KC)	1,700	Not Applicable
ICE Futures U.S. FCOJ-A (OJ)	2,200	Not Applicable
ICE Futures U.S. Sugar No. 11 (SB)	25,800	Not Applicable
ICE Futures U.S. Sugar No. 16 (SF)	6,400	Not Applicable

Energy

Contract	Spot Month	Single-Month and All Months
New York Mercantile Exchange Henry Hub Natural Gas (NG)	2,000	Not Applicable
New York Mercantile Exchange Light Sweet Crude Oil (CL)	6,000/5,000/4,000	Not Applicable
New York Mercantile Exchange NY Harbor ULSD (HO)	2,000	Not Applicable
New York Mercantile Exchange RBOB Gasoline (RB)	2,000	Not Applicable

Metal

Contract	Spot Month	Single-Month and All Months

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Commodity Exchange, Inc. Copper (HG)	1,000	Not Applicable
Commodity Exchange, Inc. Gold (GC)	6,000	Not Applicable
Commodity Exchange, Inc. Silver (SI)	3,000	Not Applicable
New York Mercantile Exchange Palladium (PA)	50	Not Applicable
New York Mercantile Platinum (PL)	500	Not Applicable

NOTES

[1] CFTC Release No. 8112-20, *CFTC Approves Two Proposed Rules at January 30 Open Meeting* (Jan. 30, 2020), https://www.cftc.gov/PressRoom/PressReleases/8112-20.

[2] Stephen M. Humenik, Clifford C. Histed & Edgar Mkrtchian, *Reconsidering CFTC Position Limits - Looking Back in Order to Look Forward to the Upcoming CFTC Position Limit Proposal* (Oct. 7, 2019), http://www.klgates.com/reconsidering-cftc-position-limits---looking-back-in-order-to-look-forward-to-the-upcoming-cftc-position-limit-proposal-09-30-2019/.

[3] Please see Appendix A.

[4] CFTC, *Fact Sheet – Notice of Proposed Rulemaking on Position Limits for Derivatives* (Jan. 30, 2020), https://www.cftc.gov/media/3376/NPRMPositionLimits_factsheet013020/download. The CFTC has stated that the Proposed Rule is intended to: (1) recognize differences across commodities and contracts, including differences in commercial hedging and cash-market reporting practices; (2) focus on derivatives contracts that are critical to price discovery and distribution of the underlying commodity, such that the burden of excessive speculation in the derivatives contract may have a particularly; and (3) reduce duplication and inefficiency by leveraging existing expertise and processes at Designated Contract Markets (each, a “DCM”).

[5] CFTC Proposed Rule, *Position Limits for Derivatives* (Feb. 27, 2020), https://www.federalregister.gov/documents/2020/02/27/2020-02320/position-limits-for-derivatives.

[6] For example, the CFTC's proposed definition of “economically equivalent swap” is generally consistent with the EU's definition except for with respect to how “identical material” terms are measured. *See Section II. Contracts Subject to the Proposed Federal Speculative Position Limits*.

[7] *See* Aggregation of Positions, Final Rule, 81 Fed. Reg. 91,454 (Dec. 16, 2016); CFTC, Staff Letter No. 17-06, (2017); CFTC, Staff Letter No. 17-37 (2017).

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[8] The CFTC's definition of “economically equivalent swap” is generally consistent with the EU's definition except that the CFTC definition disregards differences in lot size, certain delivery date differences, and post-risk management arrangements.

[9] A derivatives position may still be considered a bona fide hedge if it qualifies as either: (i) an offset of a pass-through swap, where the offset reduces price risk attendant to a pass-through swap executed opposite a counterparty for whom the swap qualifies as a bona fide hedge; or (ii) a “swap offset,” where the offset is used by a counterparty to reduce price risk attendant to a swap that qualifies as a bona fide hedge and that was previously entered into by that counterparty.

[10] Federal limits outside of the spot month would apply only to Legacy Contracts. All other CRFCs would be subject to federal limits only during the spot month and otherwise would only be subject to exchange-set limits and/or position accountability levels outside of the spot month.

[11] The Proposed Rule would also limit levels outside of the spot month at 10 percent of open interest for the first 25,000 contracts of open interest, with a marginal increase of 2.5 percent of open interest thereafter.

[12] The CFTC is proposing to define “spread transactions” by incorporating a list of transactions that would cover common types of inter-commodity and intra-commodity spreads, including, but not limited to: calendar spreads, quality differential spreads, processing spreads, product-by-product differential spreads, and futures-options spreads.

[13] The financial distress positions exemption would allow a market participant to exceed federal limits during a potential default or bankruptcy situation and would only be available on a case-by-case basis.

[14] Any swap acquired in good faith would be exempt from federal speculative position limits for purposes of complying with spot month speculative position limits.

[15] *Supra* note 5 at 11597.

[16] Kenneth Holston, Stephen M. Humenik, Edgar Mkrtchian & Matthew J. Rogers, *A Farewell to ANE: CFTC Proposes Rule to Improve Regulation of Cross-Border Swap Transactions*, (Mar. 5, 2020), http://www.klgates.com/a-farewell-to-ane-cftc-proposes-rule-to-improve-regulation-of-cross-border-swap-transactions-03-05-2020/.

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