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U.S. Commodity Futures Trading Commission Issues Final Position Limits Rule

October 26, 2020

On October 15, 2020, the U.S. Commodity Futures Trading Commission ("CFTC" or "Commission") voted to approve a final rule on position limits for commodity derivatives ("Final Rule"). The Final Rule expands the set of physically settled futures contracts covered by federal position limits from nine to 25 (such contracts, "core referenced futures contracts"), and captures certain derivatives linked to such contracts. It also revises available exemptions, including by amending the bona fide hedging regime and broadening the spread exemption.

Expansion of Covered Contracts

Historically, the CFTC's position limits covered only nine "legacy" agricultural contracts,[1] though exchanges were required to set position limits and/or accountability levels for other contracts traded on their markets.[2] The Final Rule covers 16 additional physically settled futures contracts,[3] for a total of 25 core referenced contracts. The rule also applies to other "referenced contracts," *i.e.*, contracts that are directly or indirectly linked to (1) the price of a core referenced futures contract; or (2) the price of the commodity underlying the core referenced futures contract.

In addition, the Final Rule applies position limits for the first time to swaps that are "economically equivalent" to a referenced contract. A swap is economically equivalent if its material contractual specifications, terms, and conditions are identical to a referenced contract.[4]

Revised Position Limit Exemptions

The Final Rule amends existing exemptions for bona fide hedging and spread transactions, among other exemptions.

Bona Fide Hedging

The Final Rule amends the definition of bona fide hedging to refer to "a transaction or position in commodity derivative contracts in a physical commodity, where such transaction or position:

> (i) Represents a substitute for transactions made or to be made, or positions taken or to be taken, at a later time in a physical marketing channel;
>
> (ii) Is economically appropriate to the reduction of price risks in the conduct and management of a commercial enterprise; and

[1] These contracts are CBOT Corn (and Mini-Corn) (C), CBOT Oats (O), CBOT Soybeans (and Mini-Soybeans) (S), CBOT Wheat (and Mini-Wheat) (W), CBOT Soybean Oil (SO), CBOT Soybean Meal (SM), MGEX Hard Red Spring Wheat (MWE), CBOT KC Hard Red Winter Wheat (KW), and ICE Cotton No. 2 (CT). The Final Rule raises the spot-month position limit levels for all legacy agricultural contracts except for CBOT Oats, which will maintain the existing spot-month limit levels.

[2] 17 CFR 150.5 (current version).

[3] These contracts are CME Live Cattle (LC), CBOT Rough Rice (RR), ICE Cocoa (CC), ICE Coffee C (KC), ICE FCOJ-A (OJ), ICE U.S. Sugar No. 11 (SB), ICE U.S. Sugar No. 16 (SF), NYMEX Light Sweet Crude Oil (CL), NYMEX NY Harbor ULSD Heating Oil (HO), NYMEX NY Harbor RBOB Gasoline (RB), NYMEX Henry Hub Natural Gas (NG), COMEX Gold (GC), COMEX Silver (SI), COMEX Copper (HG), NYMEX Palladium (PA), and NYMEX Platinum (PL).

[4] Swaps are still deemed economically equivalent swaps even if they differ from the referenced contract with respect to one or more of the following terms: (a) lot size specifications or notional amounts, (b) delivery dates diverging by less than one calendar day for physically settled swaps (except for natural gas swaps, which will be deemed economically equivalent unless their delivery date diverges from the referenced contract by two or more calendar days), or (c) post-trade risk management arrangement (e.g., uncleared swaps versus cleared futures contracts).

(iii) Arises from the potential change in the value of—

(A) Assets which a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising;

(B) Liabilities which a person owes or anticipates incurring; or

(C) Services that a person provides or purchases, or anticipates providing or purchasing."

Prong (i) of this revised definition reflects a change from the existing rule to conform to changes in statutory language.[5] The existing rule only requires that a transaction or position is *normally* a substitute for a position in a physical marketing channel. Commission staff previously took the view that the use of "normally" as a qualifier meant that a hedge could be bona fide even if it was not in connection with the production, sale, or use of a physical commodity.

Accordingly, CFTC staff issued a limited number of "risk management" exemptions allowing market participants to hold futures or options positions in excess of federal limits to offset their positions in commodity index swaps or related exposure, which were typically opposite institutional investors for which the swap was not a bona fide hedge. Although staff stopped granting these exemptions in or around 2008, market participants that previously received such an exemption were grandfathered. The Final Rule's elimination of the "normally" qualifier is therefore particularly significant for previously grandfathered firms, who must phase out their use of the exemption by January 1, 2023.

However, such firms will want to note that the Final Rule replaces the risk management exemption with a more limited provision for accommodating counterparties' commercial hedging needs. Specifically, the rule's bona fide hedging definition excludes paired positions of a "pass-through swap"—*i.e.*, a swap that qualifies as a bona fide hedge for one counterparty—and a "pass-through swap offset"—*i.e.*, a derivatives position that reduces the other counterparty's price risks attendant to the pass-through swap. This exclusion allows swap dealers to accommodate commercial counterparties' hedging needs and manage the risk of that accommodating position. Unlike the historical "risk management" exemption, however, this exclusion applies only if the "pass-through swap" is a bona fide hedge for the non-pass-through counterparty.

The Final Rule also clarifies that the "risk" referred to in prong (ii) of the bona fide hedging definition is limited to price risk, although the preamble acknowledges that price risk can be informed and impacted by other risks.

In addition, the Final Rule expands the existing list of "enumerated" bona fide hedges to cover additional hedging practices, including an enumerated hedge for anticipatory merchandising, which has been long-awaited by energy firms in particular.[6] Such enumerated hedges are "self-effectuating" in that a market participant need not request Commission approval prior to taking such a hedge position above the applicable federal position limit.[7] Of particular importance, the Final Rule also clarifies that an unfixed-price forward transaction may qualify for one of the enumerated anticipatory bona fide hedge exemptions. This is an addition from the most recent proposed rule, which did not address this issue.

For non-enumerated hedges, the Final Rule creates a new process for exchange and Commission approval. Under this process, if an exchange determines to grant a non-enumerated bona fide hedge recognition for purposes of its exchange-set position limits, the exchange must notify the Commission and the applicant simultaneously. Then, 10 business days (or two business days, in the case of retroactive applications filed late due to sudden or unforeseen bona fide hedging needs[8]) after the exchange issues the determination, the bona fide hedge exemption is deemed approved for purposes of federal position limits unless the Commission itself (and not Commission staff) notifies the market participant otherwise.

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[5] Before the enactment of the Dodd-Frank Act, the statutory definition of "bona fide hedging" also contained the word "normally," such that the Commission's existing bona fide hedging definition mirrored the statute. However, the Dodd-Frank Act deleted the word "normally" from the temporary substitute test. *See* Section 4a(c)(2)(A)(i) of the Commodity Exchange Act.

[6] *See, e.g.*, Transcript: CFTC Roundtable on Position Limits (June 19, 2014) (comments of Commercial Energy Working Group); Commodity Markets Council Comment Letter on Supplemental Notice of Proposed Rulemaking on Position Limits (July 13, 2016).

[7] A person with an enumerated bona fide hedge position would still need to request an exemption from the relevant exchange for any exchange-set limits, however.

[8] The Final Rule also allows a market participant with sudden or unforeseen hedging needs to file a request for a bona fide hedge exemption within five business days after exceeding the federal limit. If the Commission denies the application, the applicant will not have committed a federal position limit violation, provided it filed the application in good faith and brings the position into compliance with the applicable federal position limit within a commercially reasonable amount of time.

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Once the exchange notifies the Commission and the applicant that it has approved the application, the applicant may, at its own risk, exceed federal position limits during the Commission's 10-business-day review period. If the Commission denies an exemption application, the applicant will not have committed a federal position limits violation, provided it acted in good faith and brings the position into compliance with the applicable federal position limit within a commercially reasonable amount of time.

Finally, market participants claiming bona fide hedging exemptions will be pleased to learn that they are no longer required to file Form 204 with the Commission to demonstrate cash-market positions justifying their hedges. Instead, the Commission will have access to the cash-market information that market participants submit with their applications to an exchange for an exemption from exchange-set limits (typically filed annually).

Spread Transactions

The Final Rule also broadens the existing "spread" exemption to apply during the spot month. It defines the term "spread transaction" to include the following common types of spreads: intra-market spreads, inter-market spreads, intra-commodity spreads, and inter-commodity spreads, including calendar spreads, quality differential spreads, processing spreads (such as energy "crack" or soybean "crush" spreads), product or by-product differential spreads, and futures-options spreads. Transactions falling within this definition qualify for a self-effectuating exemption. Exemptions for spreads not enumerated in this definition must be approved by the Commission.

Overview of Final Rule

The following chart provides a high-level overview of key aspects of the Final Rule.

<table>
<tr><th>Contract Type</th><th>Spot-month limits[9]</th><th>Non-spot month limits (single month and all months combined)</th><th>Exemptions</th><th>Compliance date</th></tr>
<tr><td>"Legacy" Core Referenced Futures Contracts</td><td rowspan="4">At or below 25 percent of deliverable supply (on a futures-equivalent basis if applicable, based on the unit size of the relevant core referenced futures contract)</td><td>10 percent of open interest for the first 50,000 contracts, with a marginal increase of 2.5 percent of open interest thereafter (on a futures-equivalent basis if applicable as for the spot month)</td><td rowspan="3">Bona fide hedging
Spread transactions
Financial distress[10]</td><td>60 days after publication of the Final Rule in the Federal Register</td></tr>
<tr><td>Non-Legacy Core Referenced Futures Contracts[11]</td><td>No federal limits (exchange-set limits or accountability levels only)</td><td>January 1, 2022</td></tr>
<tr><td>Other Referenced Contracts (i.e., directly or indirectly linked)</td><td>No federal limits (exchange-set limits or accountability levels only)</td><td>January 1, 2022</td></tr>
<tr><td>Economically Equivalent Swaps</td><td>If economically equivalent to a legacy core referenced contract, same limits apply on a futures-equivalent basis.</td><td>Bona fide hedging
Spread transactions
Financial distress</td><td>January 1, 2023</td></tr>
</table>

[9] The Final Rule sets forth specific position limit levels for each contract, calculated based on updated deliverable supply provided to the Commission by exchanges.

[10] This exemption allows a market participant to exceed federal position limits if necessary to take on the positions and associated risk of another market participant during a potential default or bankruptcy situation. This exemption is available on a case-by-case basis, depending on the facts and circumstances involved.

[11] Spot-month levels apply in the aggregate across exchanges and the over-the-counter ("OTC") swap markets. During the spot month, federal position limits apply separately to physically settled and cash-settled referenced contracts, such that a market participant must aggregate its net physically settled positions, and separately its net cash-settled positions, across exchanges and the OTC swaps markets, but may not net cash-settled referenced contracts with physically settled referenced contracts. Natural gas contracts constitute the only exception to this rule: federal position limits apply to NYMEX Henry Hub Natural Gas ("NG") cash-settled referenced contracts on a per-exchange/OTC market basis (*i.e.*, cash-settled positions are not aggregated across different exchanges or the OTC market). In addition, the Final Rule creates a conditional spot-month exemption for NG only that allows a market participant to exceed the limit of 2,000 cash-settled contracts per exchange. Specifically, if a market participant does not hold any physically settled NG, it may hold up to 10,000 cash-settled NG referenced contracts per exchange, as well as an additional 10,000 equivalent-sized cash-settled economically equivalent NG swaps.

		If economically equivalent to a non-legacy core referenced contract or another referenced contract, no federal limits apply.	Exclusion for paired pass-through swap and pass-through swap offset	
Pre-enactment and transition swaps	No federal limits	No federal limits	Not applicable	Not applicable
Physical commodity contracts not subject to federal limits	Exchanges generally must set spot-month limit at no greater than 25 percent of deliverable supply, but may submit other approaches for Commission review.	Exchange may set position limits or accountability levels as "necessary and appropriate to reduce the potential threat of market manipulation or price distortion."	Exchange-set exemptions	January 1, 2022

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