



# Storm on the Horizon: Preparing for Position Limits

By Jonathan Flynn

Position limits have been the subject of considerable debate within the Commodity Futures Trading Commission and throughout the commodity and derivatives industry for several years. Now, after two proposed rules and the passing of two statutory deadlines, Chairman Gary Gensler and CFTC staff have indicated that they hope to vote on a final position limits rule as early as the public meeting scheduled for Sept. 22. If the CFTC adopts a final position limits rule that closely resembles the controversial proposed rule issued earlier this year, the debate over position limits and their potential impact on the commodity and derivatives markets is likely to continue.

In many ways, the CFTC's most recent position limits proposal represents a turning point in its regulation of the commodity and derivatives markets. As proposed, the position limits rule would impose hard limits for the first time on individually negotiated contracts that trade in the over-the-counter derivatives markets. Although the proposal would not limit positions that hedge commercial risk, the CFTC has proposed narrowing the definition of *bona fide* hedging in a way that potentially excludes certain common risk management activities. Moreover, the proposed rule would require many entities to aggregate positions held by commonly owned financial affiliates, even if the affiliate is independently controlled and

managed. Taken together, these significant changes threaten to reduce market liquidity and the overall capacity of financial institutions to provide hedging services to their commercial customers, while substantially increasing the compliance burden for all participants in the commodity and derivatives markets.

## Prologue: The Proposed Energy Position Limits Rule

On Jan. 26, 2010, six months before the Dodd-Frank Act became law, the CFTC published for comment a proposed rule that, in many ways, foreshadowed the transformational changes to the regulatory landscape that were then still on the horizon.

This proposal would have imposed new federal position limits on four energy-related futures contracts traded on the New York Mercantile Exchange—the Henry Hub natural gas contract, the light sweet crude oil contract, the New York Harbor No. 2 heating oil contract, and the New York Harbor gasoline blendstock contract—along with any other contract based on the same underlying commodities and delivery points.

Contrary to the CFTC's long-standing principles-based approach to regulation, the 2010 position limits rule outlined a markedly more rigid and formulaic approach to market regulation. If it had been adopted, this new regulatory approach would have

resulted in many significant changes for participants in the commodity and derivatives markets. For example, the 2010 position limits rule would have: (1) prohibited any trader relying on a hedge exemption from also taking a speculative position; and (2) imposed an inflexible ownership standard for account aggregation instead of the more flexible and well-established independent account controller standard that the CFTC and the exchanges currently use to disaggregate commonly owned, but independently controlled positions. Over 8,000 comments were filed in response to these and other aspects of the energy position limits rule before it was withdrawn on Aug. 18, 2010 following the enactment of the Dodd-Frank Act.

### Position Limits in the Post-Dodd-Frank World

The Dodd-Frank Act amended the Commodity Exchange Act to authorize the CFTC in specified circumstances and subject to specified conditions to set limits on the

- Establish hard position limits (rather than exchange-set accountability levels) on 28 core physical-delivery contracts and their “economically equivalent” derivatives.
- Set spot-month position limit levels at 25% of deliverable supply for a given commodity, with a conditional spot-month limit of five times that amount for entities with positions exclusively in cash-settled contracts.
- Set non-spot-month position limit levels at 10% of open interest below the first 25,000 contracts plus 2.5% thereafter for each referenced contract.
- Establish separate and aggregate position limits for non-spot-month positions consisting of single-month and all-months-combined positions across classes for all exchange-traded futures and options, and all swaps.
- Permit exemptions for certain *bona fide* hedging transactions and for positions that are established in good faith prior to the effective date of specific limits adopted pursuant to the proposed regulations.

collects position data on physical commodity swaps. The initial spot-month position limits would be based on deliverable supply determined by levels currently set by the exchanges. Later, after sufficient market data is available, the CFTC would set spot month position limits based on the CFTC’s determination of deliverable supply, and position limits outside of the spot month based on the CFTC’s determination of aggregate open interest. As proposed, the all-months-combined aggregate and single-month position limits outside the spot month would be calculated according to a fixed formula (10% of the first 25,000 contracts of average all-months-combined aggregated open interest, plus of 2.5% thereafter). Position limits calculated using this formula could be self-effectuating as soon as the necessary data are available (i.e., new position limits outside the spot month could be imposed without any additional rulemakings or opportunity for notice and public comment).

The large trader reporting rule for physical commodity swaps adopted on



**Contrary to the CFTC’s long-standing principles-based approach to regulation, the 2010 position limits rule outlined a markedly more rigid and formulaic approach to market regulation.**

size of positions, other than *bona fide* hedging positions, in futures, options on futures, and swap contracts involving exempt and agricultural commodities that may be held by any person. Unlike most other provisions in the legislation, the positions limits provision became effective upon enactment on July 21, 2010. The Dodd-Frank Act directed the CFTC to determine whether new position limits were necessary by Jan. 17, 2011 for exempt commodities (e.g., metals and energy products), and by April 17, 2011 for agricultural commodities; however, the CFTC has not met either deadline.

Instead, on Jan. 26, 2011, exactly one year after the 2010 position limits rule was published, the CFTC proposed a new position limits rule that, in many respects, was similar to the first proposal, but broader because it included swaps and many physical commodities other than the four products listed in the earlier proposal. This proposal will be the basis for the final rule that could be adopted as soon as Sept. 22 and many of its key provisions may be retained in the final rule. Among other things, the proposed rule would:

- Establish new account aggregation standards to replace the CFTC’s current position limits aggregation policy.
- Establish a new “position visibility reporting regime” for five Nymex metals contracts, four Nymex energy contracts, and “paired” contracts that are economically equivalent to these contracts (e.g., the ICE WTI contract) that is similar to current reporting obligations for large *bona fide* hedgers.

Notably, unlike the 2010 position limits rule, the new position limits proposal eliminated the provision that would have “crowded out” a trader’s ability to take speculative positions once that trader relies on a hedge exemption.

### Phased Approach

The new position limits proposal also responded to concerns about whether the CFTC had adequate market data to properly set position limits by proposing to implement them in two phases, with the first phase applying only to spot months and the second phase delayed until after the CFTC

July 22, 2011 will allow the CFTC to start collecting the data it needs to calculate deliverable supply and open interest for the 28 core physical-delivery contracts and economically equivalent swaps. However, even though the large trader reporting rule becomes effective on Sept. 20, 2011, swap dealers that are not members of a clearinghouse will not be required to report any position data until after the CFTC adopts the final “swap dealer” definition in late 2011 or early 2012. Moreover, other rules related to swap data repositories and the reporting of swap transaction data will not be fully implemented until fall 2011 at the earliest, and although the CFTC is required to provide a transition period of at least 60 days before new rules become effective, the CFTC is expected to defer effective dates for at least some of these rules so that market participants have adequate time to develop and implement the required technology and new reporting systems. As a result, in practical terms it may be months (if not years) until the CFTC

has the information that it needs to fully effectuate the new position limits rule.

## Real Problems Would Not Be Deferred

The new position limits proposal retains many potentially problematic features from the earlier proposal, and raises several new issues that were not present before. Even if some aspects of the proposed rule would not take effect until next year (or later), many provisions in the new position limits rule would have an immediate and significant impact on the commodity markets and businesses that use derivatives to hedge commercial risk.

■ **Narrower Definition of *Bona Fide* Hedging.** The proposed rule would limit the definition of *bona fide* hedging to a short list of enumerated hedging transactions all based on owning, purchasing, or selling one of the referenced contracts or the corresponding underlying commodity. Significantly, the proposed rule

commercial entities to fully hedge the risks associated with their businesses.

■ **No Mechanism for Obtaining Risk Management Exemptions.** The proposed rule provides no mechanism for liquidity providers to obtain risk management exemptions for transactions that hedge the risks associated with swaps that serve the same purpose as *bona fide* hedging transactions (i.e., they manage risk and, therefore, promote the financial stability of providers of swaps and other risk management instruments), but that may not fall within the CFTC's narrow definition of *bona fide* hedging. For example, as proposed, the new position limits rule could limit the ability of commodity index funds to obtain hedging services through financial intermediaries. Without access to cost effective hedging services, these funds may be forced to assume more risk or hedge their exposure in foreign markets. This is particularly significant because Congress specifically

controller exemption with a limited exemption from mandatory aggregation that would allow an entity to disaggregate the positions of a non-financial affiliate in which it holds a 10% or greater equity interest from its own directly held or controlled positions only if the entity can demonstrate that the non-financial affiliate is independently controlled and managed. The new position limits proposal also provides a narrow exemption from aggregation for certain independently controlled and managed accounts of a futures commission merchant and its affiliates. An entity would not be permitted to disaggregate the positions of a financial affiliate in which it holds a 10% or greater equity interest, even if it can demonstrate that the two entities have no common control or management. Moreover, because disaggregation requests would not be conditionally effective upon filing, every entity that holds a 10% or greater equity interest in another entity would be required to aggregate their



Congress specifically directed the CFTC to ensure that U.S. position limits are comparable to limits imposed by non-U.S. regulators and do not cause price discovery to shift to trading on foreign boards of trade. ”

would eliminate the mechanism in Part 1.3(z)(3) by which a hedger could apply for an exemption for non-enumerated hedging transactions. As a result, it is unclear whether certain types of common hedging transactions would qualify as *bona fide* hedging transactions under the proposed rule, including

- Hedges of inventory or other assets that a commercial entity anticipates owning;
- Hedges of liabilities or services that a company anticipates incurring or providing; and
- Hedges of assets that a person merchandizes or anticipates merchandizing.

The proposed definition of *bona fide* hedging also appears, perhaps inadvertently, to exclude swaps used to hedge the sales of an underlying commodity, including swaps that qualify for the end user clearing exception. A narrow definition of *bona fide* hedging would potentially reduce liquidity in listed and over-the-counter derivatives markets and complicate the efforts of many

directed the CFTC to ensure that U.S. position limits are comparable to limits imposed by non-U.S. regulators and do not cause price discovery to shift to trading on foreign boards of trade.

- **No Hedging on a Portfolio Basis.** Contrary to common practice in many industries, the proposed rule would apparently prohibit entities relying on a *bona fide* hedging exemption from hedging their risk on a portfolio basis. As a result, if adopted in its current form the new position limits rule would require each *bona fide* hedge position to be tied to a corresponding physical transaction or position. This would make it more difficult for hedgers to adjust their positions in response to changing market conditions in order to optimize the value and minimize the risk associated with their overall portfolios.
- **Limited Exemption from Mandatory Aggregation for Commonly Held Accounts.** The new position limits proposal replaces the current independent account

positions until the CFTC grants a disaggregation request.

If adopted as proposed, the new aggregation requirement will have a profound effect on the affiliates of large, integrated commodity and derivatives market participants that currently operate under the CFTC's long-standing position limit and aggregation rules. For example, the new position limits rule would require the common parent of an integrated group of financial service companies to aggregate all positions in referenced contracts traded by a dealer subsidiary on its behalf with all positions in referenced contracts traded independently by its walled-off asset management subsidiaries on behalf of their third party clients due to the ultimate common ownership of the companies, despite the absence of common ownership of the positions and the absence of common control with respect to the trading activities.

- **Anticipatory Hedge Exemptions Limited to One Year.** The new position lim-

its proposal appears to restrict anticipatory hedge exemptions to transactions (as opposed to the exemption itself) with terms of one year or less. As a result, if adopted in its current form, the new position limits rule could make it impossible to hedge some long-term transactions more than one year into the future, including infrastructure projects that often require multi-year hedges to secure financing. For example, purchasers of power plants often hedge the power plant's anticipated production and fuel requirements ten years or longer into the future to provide support for the acquisition financing. If anticipatory hedge exemptions are limited to transactions of one year or less, it may be more difficult to finance large transactions and major infrastructure projects cost effectively.

- **No Prospective Hedge Exemption Application Process.** In contrast to the long-standing practice of allowing traders to apply for hedge exemptions in ad-

to hedge the risk associated with a swap with a counterparty that is itself relying on a *bona fide* hedge exemption to exceed its position limits to: (1) obtain a representation from the counterparty that the swap qualifies as a *bona fide* hedging transaction; and (2) provide written confirmation of such representation to the counterparty, both on a transaction-by-transaction basis. If the swap is a hedge for both parties, both parties must comply with the representation and confirmation process. It is unclear whether the parties must wait until all written confirmations have been exchanged before entering into a hedging transaction without risk that the transaction will be subsequently disqualified after-the-fact or potentially cause the hedger to exceed its speculative position limit. The proposed representation and confirmation process could create significant administrative and operational burdens for market participants, particularly if transactions can-

Electric Institute and Electric Power Supply Association noted that the CFTC's definition of "deliverable supply" that would be used to calculate spot-month position limits is out-of-date because it does not account for important new settlement options and other market mechanisms that provide flexibility to users of physical commodity futures, swaps, and other derivatives products. They asserted that by not considering the impact of "exchange for physical transactions" and other well-established settlement options, the proposed rule would impose unnecessary and detrimental restrictions on physically-settled commodity transactions.

### Moving Forward

Every entity that uses the commodity and derivatives markets to hedge or mitigate commercial risk will need to scrutinize carefully the new position limit rule after it is adopted by the CFTC. The new position limit rule may affect liquidity in many of the affected contracts, particularly in de-



**Over 13,000 comments were filed in response to the new position limit rule by a wide variety of market participants and other interested parties.**

vance, the proposed rule would require all traders that exceed a position limit in reliance on a *bona fide* hedge exemption to file a detailed report with the CFTC by 9:00 a.m. on the next business day and everyday thereafter on which the trader continues to exceed the limit. Not being able to request hedge exemptions prospectively may create uncertainty, particularly for traders that need to hedge risks that do not correspond precisely in time or quantity to available hedging products because there will be no formal mechanism for the CFTC to review and respond to questions about the validity of the hedge before it is put in place. Moreover, daily reporting will require hedgers to develop substantial operational and technological resources to collect and synthesize the required information, especially firms that operate globally, across multiple time zones.

- **Other Frequent and Complex Reporting Requirements.** The new position limit rule would require any person that relies upon a *bona fide* hedge exemption

not be executed until all of the required documents have been acknowledged and exchanged.

### Large Response to New Position Limit Proposal

Over 13,000 comments were filed in response to the new position limit proposal by a wide variety of market participants and other interested parties. Many of the comments raised important, substantive issues that the CFTC is obligated to consider before adopting a final rule. For example, the International Swaps and Derivatives Association and the Securities Industry and Financial Markets Association jointly commented that the new position limit rule would unnecessarily restrict the ability of market intermediaries to use position limits that are "passed-through" by their swap counterparties. As a result, this aspect of the new position limit rule would inadvertently make it more difficult for intermediaries to accommodate demand for near-term risk management services from commercial end users. Similarly, the Edison

ferred months and at infrequently traded delivery points. If liquidity decreases, it likely will be more costly for commercial enterprises to hedge the risks associated with their businesses. Significantly, if the new position limit rule retains many of the provisions described above, these entities will need to start making significant and costly changes to their businesses to ensure that they continue to comply with their regulatory obligations. Aside from amplifying the uncertainty associated with the Dodd-Frank implementation process, such changes would virtually guarantee that the debate over position limits will continue for the foreseeable future. ■

.....

**Jonathan Flynn** is an attorney with Cadwalader, Wickersham & Taft LLP based in Washington, D.C. and regularly counsels participants in the commodity and derivatives markets on a wide range of regulatory and compliance issues, including implementation of the Dodd-Frank Act. The author wishes to thank **Paul Pantano** for his substantive guidance and editorial advice on the article.