



## SECURITIES AND FUTURES REGULATORY UPDATE

### CFTC Position Limits Rulemaking

#### Introduction and Effectiveness Dates

On October 18, 2011, the Commodity Futures Trading Commission (“CFTC”) adopted final regulations on position limits, revising the CFTC’s publication on January 26, 2011 of a proposed rule establishing a position limits regime for 28 exempt and agricultural commodity futures and options contracts and the physical commodity swaps that are economically equivalent to these futures and options contracts. The CFTC undertook this rulemaking process to implement Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Reform Act”), which was part of a larger Congressional goal of establishing a comprehensive new regulatory framework for swaps and security-based swaps. The position limits rulemaking is part of an attempt to limit “excessive speculation” that would cause “sudden or unreasonable fluctuations or unwarranted changes” in the price of commodities futures and options contracts, while also preserving the ability for *bona fide* hedgers to have access to an effective market with sufficient liquidity and price discovery to allow them to hedge legitimate risk. The final position limits rule, made available on the CFTC’s website on October 26, 2011,<sup>1</sup> will go into effect 60 days after the term “swap” is further defined pursuant to Section 721 of the Reform Act, both with respect to futures and options contracts and swaps that are economically equivalent, with one exception: Referenced Contracts (as defined below) that are not one of the nine “legacy” agricultural Referenced Contracts and that currently are not subject to CFTC position limits will be subject to the position limits final rule by order of the CFTC after the CFTC has received one year of open interest data on physical commodity cleared and uncleared swaps under the swaps large trader reporting rule. The CFTC has stated that it intends to adopt a final definition of “swap” before year-end, although, as with some of the other rulemakings, this definitional rulemaking could be delayed until 2012.

#### Products Subject to Position Limits

The final rule establishes speculative position limits for 28 physical commodity futures and options contracts (“Core Referenced Futures Contracts”) traded according to the rules of a designated contract market (“DCM”), as well as physical commodity swap contracts that are “economically equivalent” to these 28 futures and options contracts (collectively with Core Referenced Futures Contracts, “Referenced Contracts”). The speculative limits on (i) the DCM-traded Core Referenced Futures Contracts and (ii) the non-DCM-traded “Non-Core Referenced Futures Contracts,” Referenced Contracts that are not DCM-traded Core Referenced Futures Contracts, will be imposed simultaneously

<sup>1</sup> The final position limit rules are available from the CFTC’s website at <http://www.cftc.gov/PressRoom/Events/federalregister101811c>; however they have not yet been published in the Federal Register.

upon the final rule becoming effective. The CFTC selected the 28 Core Referenced Futures Contracts based on the levels of open interest and significant notional value and serving as reference prices for a significant number of cash market transactions. The Core Referenced Futures Contracts are comprised of (i) nine “legacy” agricultural contracts, (ii) ten non-“legacy” agricultural contracts, (iii) four energy contracts and (iv) five metal contracts.

A swap contract may be “economically equivalent” to one of the Referenced Contracts if one of the following conditions is satisfied:

- i. it is a “look-alike” contract in that it settles off of a Core Referenced Futures Contract or contracts that are based on the same commodity for the same delivery location as a Core Referenced Futures Contract;
- ii. it is a contract with a reference price based only on the combination of at least one Referenced Contract price and one or more prices in the same or substantially the same commodity as that underlying the relevant Core Referenced Futures Contract;
- iii. it is an intercommodity spread contract with two reference price components, one or both of which are based on Referenced Contracts; or
- iv. it is priced at a fixed differential to a Core Referenced Futures Contract.

## How Position Limits Work

Speculative position limits will apply in two types: **spot-month position limits** and **non-spot-month positions limits**. **Spot-month position limits** apply (i) immediately before physical delivery contracts become subject to delivery obligations or (ii) immediately before cash-settled contracts are liquidated based on a reference price, and are generally set at 25% of estimated deliverable supply, as determined by the CFTC in consultation with DCMs; while **non-spot-month position limits** apply to positions held by an individual market participant in all contract months combined or in a single contract month and will generally be set at 10% of open interest in the first 25,000 contracts and 2.5% of the open interest thereafter. The spot-month position limits will apply separately, at the same numerical levels, for positions in physically delivered contracts and cash-settled contracts. Non-spot-month position limits do not impose this physical-cash separation and consequently allow for the netting of offsetting positions as between cash- and physically-settled contracts on the same commodity.

While the final position limits rule generally will go into effect 60 days after the term “swap” is further defined pursuant to Section 721 of the Reform Act, thereafter the numerical spot-month position limit levels will be adjusted biennially for energy and metals and annually for agricultural contracts, and numerical non-spot-month position limit levels for all types of contracts will be adjusted biennially. The final rule will also allow for DCMs to petition the CFTC to update the limits on a more frequent basis should supply and demand fundamentals warrant it.

The final rule establishes an exception, though, for NYMEX Henry Hub Natural Gas contracts. While it appears that physical delivery contracts will be subject to the spot-month position limit described above, there will be different limits for contracts subject to a cash-settled spot-month position limit and there will be an aggregate limit, each set at five-times the limit that applies to the physical delivery NYMEX Henry Hub Natural Gas contracts. This exception for NYMEX Henry Hub Natural Gas contracts is a deviation from the proposed rule, which contained this “five-times” exception for all cash-settled contracts.

The final rule includes a position visibility reporting regime, which sets quarterly position reporting requirements for traders exceeding specified non-spot-month position visibility levels in energy and metal Referenced Contracts. The CFTC will use this regime to make future adjustments to the position limit framework for energy and metal Referenced Contracts.

## Bona Fide Hedging Transactions

The currently available enumerated position limit exemptions for *bona fide* hedging transactions have been broadened, such that certain contracts that previously would not have been eligible for an enumerated exemption, including certain anticipated merchandising transactions, royalties and service contracts, may now be traded on a *bona fide* hedging transaction basis by the relevant commercial firms. However, the non-enumerated category of hedge exemption has been eliminated. The CFTC rulemaking also provides an exemption for situations involving financial distress. Positions in any of the Referenced Contracts entered into prior to effectiveness of the rule that were entered into in good faith are not subject to position limits.

## Exemption from Aggregation in Certain Cases

The proposed rule put forth by the CFTC would have fully removed the Independent Account Controller (“IAC”) exemption. In response to numerous comments, the CFTC reversed course and determined to retain the IAC exemption largely as currently in effect under 17 CFR §150.3(a)(4), with clarifications to make explicit the CFTC’s long-standing position that the IAC exemption is limited to client accounts that one trades professionally for others pursuant to a fiduciary relationship. The IAC exemption does not extend to proprietary positions in accounts which an eligible entity owns even if the accounts are controlled by an IAC. Under the IAC exemption, an eligible entity, which includes mutual funds, banks, commodity pool operators, commodity trading advisors and insurance companies, may disaggregate customer positions or accounts managed by an IAC from the eligible entity’s other separately-controlled positions (outside of spot months). An IAC must trade independently of the eligible entity and other IACs trading for the eligible entity subject to an appropriate trading data firewall, and each IAC must trade such accounts pursuant to separately developed and independent trading systems. The determination of whether to aggregate different accounts or positions will be made by the CFTC on a case-by-case basis. When determining whether to aggregate different accounts or positions, the CFTC will look to factors or indicia of control, such as whether a firewall exists separating the trading functions of the IAC and the eligible entity.

Under the rule, a trader must aggregate all positions in accounts in which the trader, directly or indirectly, holds an ownership or equity interest of 10% or more, *as well as* accounts over which the trader controls trading. Each of several traders that owns an interest greater than or equal to 10% in an account in which Referenced Contracts are traded will be required to aggregate all of the positions in that account with all of the trader’s other positions. Traders acting pursuant to an express or implied agreement or understanding will be treated the same as if the positions were held by a single trader. **Notably, this 10% equity interest threshold means that the proprietary trading positions and accounts of a company or other trader will be aggregated, in the absence of one of the exemptions provided below.**

The CFTC included an exemption from this aggregation of positions when a person owns more than 10% of an account or position if that account or position is associated with the underwriting of securities (but not as to positions held in controlled accounts). Furthermore, an exemption will be allowed in instances in which aggregation across commonly-owned affiliates would require position information sharing that would result in violation of federal law (*e.g.*, information sharing in violation of FERC affiliate rules), subject to filing of a notice and obtaining an opinion of counsel. However, this exemption will not apply to situations in which a trader has actual knowledge of the positions of an affiliate.

The CFTC further determined to maintain the current exemption for mere ownership interests in commodity pools under §150.4(b). Under this exemption, a trader who is also a mere limited partner or shareholder in a commodity pool generally will not need to aggregate *if the trader does not control the pool’s trading decisions.*<sup>2</sup> Therefore, a fund of funds manager investing solely in funds or accounts managed by third-parties that maintain positions in Referenced Contracts

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<sup>2</sup> This exception does not apply to the pool’s commodity pool operator.

should not be subject to aggregation of positions under this rule, assuming it does not have side letter agreements giving it control over investment decisions of the funds or accounts in which it invests. If the trader is also a principal or affiliate of the pool's CPO, the trader need not aggregate so long as the trader does not control or supervise the pool's trading and the pool operator has proper informational barriers.

A trader must nevertheless aggregate positions arising out of interests in funds or accounts with identical trading strategies. *This includes interests in passively-managed index funds*, if those accounts or pools have identical trading strategies. Out of a concern that investors could use positions in funds or accounts with identical trading strategies to circumvent this rule, *there is no 10% ownership threshold for these purposes*; positions arising out of interests of any size in an account or pool would require aggregation. However, the rule appears to craft this "identical trading strategies" aspect rather narrowly; the release uses the example of a "long-only position in a given commodity" as an identical trading strategy. The rule therefore may not require aggregation of positions arising out of substantial ownership interests in multiple index funds with similar, but slightly different, trading strategies. For example, an investment in an index fund comprised of both gold and silver price index components arguably is not identical to an investment in an index fund based on the price of gold exclusively.

A trader seeking to disaggregate positions otherwise subject to aggregation will be required to file an application for relief with the CFTC. The application must set forth the circumstances that warrant disaggregation and a certification that the applicant meets the conditions relevant to exemption. Under the proposed rule, an applicant would have been required to file annual renewals. *The final rule does not include the annual renewal requirement*. In the event of a material change to the information provided in the application filed, though, an updated or amended application must promptly be filed detailing the material change.

## **No Exemption for Commodity Index Funds**

With respect to commodity index funds ("CIFs"), the CFTC did not finalize rules to impose different position limits or to exempt CIFs from position limits applicable to Referenced Contracts. Instead, the CFTC stated in adopting the final rule that more analysis is required before it would impose a separate position limits regime or establish an exemption for a class of traders such as CIFs.

If you have any questions regarding this update, please contact the Sidley lawyer with whom you usually work.

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