

## Position Limits for Commodity Derivatives Under Dodd-Frank

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June 1, 2011

This article discusses the recently proposed position limits for derivatives. All of the rules discussed in this article are currently in proposal and comment phase and the final effective rule may be different.

On January 13, 2011, the Commodity Futures Trading Commission (CFTC) issued proposed rules mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) that outline a position limits regime for contracts referencing 28 metal, energy and agricultural commodities. The proposal lists 28 specific futures contracts traded on specific futures exchanges in the U.S., which are called "core contracts." The limits will apply to core contracts, options on core contracts and swaps that are "economically equivalent" to such contracts.

The CFTC has already missed the Dodd-Frank deadlines for the implementation of position limits rules. Nevertheless, once the rules become final, the CFTC intends to implement them in two distinct phases.

In phase one of the implementation, the CFTC will adopt the spot-month position limits currently set by the regulated futures exchanges as well as the new bona fide hedging and account aggregation rules. These interim position limits will remain effective until the enactment of the second phase.

In the second phase, the CFTC will establish spot-month limits (using the exchanges' estimates or its own estimates) and non-spot-month limits which will be determined using data collected in the upcoming months. The limits will be set annually by January 31st of each calendar year and will be published on the CFTC's website prior to becoming effective on March 1 of each calendar year.

### **What are position limits, and why are they being imposed**

Position limits specify the maximum number of contracts in covered commodities that any one non-hedging market participant may hold. The CFTC considers position limits necessary to minimize market disruptions and price distortions resulting from excessive speculative trading. This has been a controversial issue and many market participants have argued that there is no evidence that speculative trading resulting in large positions causes the ills that are ascribed to it. Nevertheless, these objections have not had any traction and Dodd-Frank has given the CFTC expanded authority in this area by requiring the agency to include swaps in addition to futures contracts under its position limits regime. The trend, therefore, is in favor of expanding rather than position limits oversight – for the near future, at least.

### **Currently applicable position limits**

Position limits are established in one of two ways, depending on the commodities involved. For certain designated agricultural commodities, the CFTC establishes the applicable limits and for all other commodities, limits are established by the exchange on which the commodity contract is traded, pursuant to core principles set out in the Commodity Exchange Act (CEA). The current limits apply only to futures contracts and options on futures contracts and do not apply to swaps.

## **Dodd-Frank changes to the current regime – limits on "economically equivalent" swaps**

Dodd-Frank authorizes the CFTC to expand the limits regime to "economically equivalent" swaps. Under the proposed rules, a swap is considered "economically equivalent" to a core futures contract if either: (1) the price of the swap refers to a covered futures contract settlement price; or (2) the swap is priced on the same commodity delivered at the same location, or at locations with substantially the same supply and demand characteristics, as that of any of the core contracts.

This definition, especially given the level of customization in the swaps world, will likely present the CFTC with some difficulty, especially in trying to determine which delivery locations have the "same supply and demand characteristics." For some corn contracts, like the CBOT corn for example, this may be simpler because the delivery location is specified in the contract – Chicago, Indiana, Lockport, Ottawa or Peoria. Some of the metals core contracts, however don't have named delivery locations but refer to warehouses specified by the exchange.

In the past, when swaps were not counted toward position limits, traders that approached or breached limits in the futures markets could continue to increase their exposure to the particular commodity by entering into swap transactions that mimicked the economics of the futures contract. That ability is now precluded by Dodd-Frank which, together with tougher aggregation rules discussed below, has the potential to cause serious disruptions in the trading strategies of certain market participants.

### **Calculation of limits**

*Spot-month limits.* Spot-month is the month in which a futures contract expires. Generally, it is regarded that large positions in the spot month are most capable of influencing the price of the physical commodity. The CFTC proposes to determine spot-month limits based on estimated deliverable supply of the commodity in question, which is the method currently used by the futures exchanges to set their own spot month limits. "Deliverable supply" generally means the quantity of the commodity that can reasonably be expected to be readily available to fulfill the outstanding contract obligations, barring any abnormalities in interstate commerce. Each regulated futures exchange would have to submit to the CFTC an estimate of deliverable supply by December 31 of each year. Initially, the CFTC will adopt the exchange spot-month limits but in the future may decide to use its own estimate of deliverable supply when setting position limits. There is some concern whether CFTC is equipped to perform such estimates.

For physical delivery contracts, spot-month position limits would be set at 25 percent of estimated deliverable supply. Traders holding cash-settled positions (that do not involve the delivery of a physical commodity at settlement) could hold position levels equal to five times the spot-month limit if the trader's physical commodity positions do not breach the 25 percent limit.

Spot-month position limits will only apply to positions in physical delivery or cash-settled referenced contracts with delivery locations that match the delivery locations of the core futures contracts in the same commodity. For example, an economically equivalent swap that references the relevant commodity but whose price is based on a different delivery location would not be subject to spot-month position limits.

*Class and aggregate non-spot month limits.* Because Dodd-Frank requires the CFTC to include swaps under the position limits regime, the proposal creates two classes of contracts for non-spot month limits: (1) futures and options on futures contracts and (2) swaps. In addition to the aggregate position limits that will apply across classes, the proposal applies single-month and all-months-combined position limits to each class separately. As a result of that classification, there are a total of six possible non-spot-month position limits: (1) futures/options class single-month limit, (2) futures/options class all-months-combined limit, (3) swap class single-month limit, (4) swap class all-months-combined limit, (5) aggregate single-month limit and (6) aggregate all-months-combined limit. In practical terms however, there will be three

limits, actually, since the CFTC is proposing to make the single month and the all-months-combined limit the same.

Unlike spot-month limits which are based on deliverable supply, the proposed class and aggregate limits will be tied to a specific percentage of overall open interest for a particular covered contract in the aggregate or on a per class basis. Both the class and the aggregate limits will be calculated based on the same formula and will equal 10 percent of the first 25,000 contracts of open interest, and 2.5 percent of the open interest for any amounts above 25,000 contracts. The average all-months-combined aggregated open interest, which is the basis of these calculations, is determined annually by adding the all-months futures open interest and the all-month swaps open interest for each of the 12 months prior to the effective date and dividing that amount by 12. Each trader's positions would be netted for the purpose of determining compliance with position limits.

As an exception to the general open interest based formula, proposal retains existing position limits for nine covered agricultural contracts listed in current CFTC rule 150.2.

### **Exemptions from position limits regime – bona fide hedging**

The position limits regime, in all its iterations, has always included some form of hedging exemption. The rationale is that companies that use the futures markets to reduce the risks inherent in operating commercial enterprises are not in the market to speculate and should therefore not be constrained by position limits in their legitimate hedging activities.

The CFTC proposal would significantly narrow the availability of the bona fide hedging transaction compared to its current iteration. For example, unlike the current definition, the proposal allows the exemption only for transactions that represent a substitute for a physical market transaction. The concern of many market participants is that this appears to exclude legitimate hedging strategies, such as portfolio hedging, that are currently at their disposal and to require rigid one-on-one hedging. The proposed definition also will not exempt swap dealers when offering risk management products to market participants seeking to hedge financial risk unrelated to physical market exposure, which is allowed under the current rule. Instead, a swap dealer may rely on the exemption only in connection with risk reducing positions entered into under a swap with a counterparty that qualifies as a bona fide hedger.

### **Aggregation**

Obviously, if position limits were determined on an account by account basis, a single trader could open many different accounts and hold positions in each account up to the applicable limits and thus formally be in compliance with the rule. The aggregation rules address this by combining all accounts that a trader, directly or indirectly, controls or has at least a 10 percent equity interest in, for the purposes of determining compliance with position limits. In addition, positions held by two or more traders acting pursuant to an express or implied agreement or understanding would be combined in the same as if the positions were held by a single trader.

In a significant departure from the current regime, the CFTC's proposal eliminates the independent account controller exemption. This exemption, set forth in current CFTC rule 150.3, allows certain types of accounts held by a single entity but which are controlled by traders that operate independently from one another and where there is no centralized oversight of trading, to be disaggregated. The exemption is premised on the fact that accounts that are under separate management need not be aggregated because they have no combined effect on the market. This would no longer be allowed under the proposal and all such accounts would have to be combined and attributed to the holding or controlling entity. If adopted, this change will especially affect large financial institutions that may have a multitude of desks that engage in commodities trading for varied purposes and whose positions, when so combined,

will likely breach the applicable limits. In addition, these proposed aggregation requirements will meaningfully impact the trading strategies of collective investment vehicles such as commodity pools, hedge funds and mutual funds.

### **Consequences of breach**

In enforcing the position limits regime, the CFTC relies on the daily large trader reporting requirements to monitor positions of market participants. The CFTC can conduct administrative proceedings, impose fines and prevent the violating trader from trading for a certain period of time. It is interesting to note that CFTC enforcement is not predicated on the existence of a CFTC-imposed position limit. Even before the expanded activity in this area mandated by Dodd Frank, a violation of a position limits imposed by a futures exchange and approved by, or certified to, the CFTC was a statutory violation of the CEA.

### **About the Authors**

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