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CFTC Proposes To Allow Designated Contract Markets and Swap Execution Facilities To Recognize Certain Hedging and Spread Positions From Speculative Position Limits

On May 26, the Commodity Futures Trading Commission (CFTC) proposed amendments to its previously proposed rules related to speculative position limits on 28 core referenced futures contracts (the "2016 Amendment"). If adopted, the 2016 Amendment would allow designated contract markets (DCMs) and swap execution facilities (SEFs) to recognize certain non-enumerated *bona fide* hedging positions (NEBFHs) and certain enumerated anticipatory *bona fide* hedging positions[1] as well as to grant exemptions from position limits for certain spread positions.[2] The 2016 Amendment also amends certain definitions, including the definition of *bona fide* hedging position, and delays the establishment and monitoring of exchange-set swaps position limits for exchanges that do not have access to sufficient swap position information.

Previous CFTC Position Limits Proposals and Rulemaking

The CFTC issued proposed position limits and aggregation rules in 2013 (collectively, the "2013 Proposal"), which sought to expand speculative position limits requirements with respect to futures, swaps and options and contained rules dictating the aggregation of positions on the basis of control and ownership. The 2013 Proposal identified 28 core referenced futures contracts which included agricultural, energy and metal products and provided for three types of position limits: spot month, single month, and all months combined. Position limits would be applied to all derivatives contracts that are directly or indirectly linked to the price of a core referenced futures contract or based on the price of the commodity underlying a core referenced futures contract for delivery at the same location as such contract. The 2013 Proposal was intended to replace the CFTC's Part 151 rules pertaining to position limits for futures and swaps, which were adopted on October 18, 2011 and vacated on September 28, 2012 by the U.S. District Court for the District of Columbia.[3]

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[1] The 2016 Amendment defines a *bona fide* hedging position as a position that is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise and that is either (i) a position listed in proposed Section 150.1(3)-(5) which is considered, on its face, to be a *bona fide* hedging position (an enumerated hedging position) or (ii) a position that is recognized as a *bona fide* hedging position by a DCM or SEF pursuant to the rules of the DCM or SEF which have been submitted to the CFTC for review (a non-enumerated hedging position). The positions listed in proposed Section 150.1(3)-(5) include hedges of inventory and cash commodity position contracts, hedges of cash commodity sales contracts, hedges of unfilled anticipated requirements, and hedges by agents.

[2] Because the proposed rules relating to DCMs and SEFs are essentially identical, as used in this Advisory, the term "exchanges" should be read to mean both DCMs and SEFs.

[3] *International Swaps and Derivatives Association v. United States Commodity Futures Trading Commission*, 887 F. Supp.2d 259 (D.D.C. 2012).

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The 2016 Amendment was driven by comments received by the CFTC in response to the 2013 Proposal, which suggested that exchanges should play a role in the recognition of non-enumerated *bona fide* hedging exemptions as they do currently, and that disagreed with the elimination of the spread position exemption from speculative positions limits.

This Advisory provides a summary of the key components of the CFTC's most recent proposal.

Exchange Recognition of Positions as Non-Enumerated *Bona fide* Hedges

In contrast to the 2013 Proposal, which contemplated that the CFTC would be the sole entity with the ability to recognize NEBFHs, the 2016 Amendment contemplates that an exchange may request authority to process the applications of position holders who seek to have their positions recognized as NEBFHs with respect to federal speculative position limits.[4] The CFTC notes that the involvement of an exchange, acting as a self-regulatory organization with oversight from the CFTC, leverages the exchange's familiarity with the trading activity on the exchange and associated market participants while retaining the CFTC's ability to monitor trading across futures and options markets.

Application Process

An exchange that elects to process non-enumerated *bona fide* hedging position applications must first file proposed rules with the CFTC pursuant to Part 40 of the CFTC's regulations that establish an application process consistent with the proposed rules.[5] An exchange may process applications with respect to a commodity derivatives contract only if: (1) such contract is a referenced contract; (2) the exchange lists such contract for trading; (3) such contract is actively traded on the exchange; (4) the exchange has established position limits for such contract; and (5) the exchange has at least one year of experience administering position limits for such contract. An applicant must receive recognition of an NEBFH position before exceeding a position limit and must reapply on an annual basis in order to maintain a position in excess of a position limit.

An exchange must gather from market participants certain information through the application process, including: (1) a description of the position for which the application is submitted and offsetting cash positions; (2) a demonstration that the position satisfies Section 4a(c) of the Commodity Exchange Act (CEA) and the proposed definition of *bona fide* hedging position; (3) a statement of the maximum gross positions in the derivative contract to be acquired by the applicant during the year after the application is submitted; (4) information concerning the applicant's activity in the cash markets of the commodity underlying the position for the past three years; and (5) any other information necessary for the exchange or CFTC to determine whether recognition as an NEBFH is appropriate. An exchange can recognize a smaller position than is requested under any particular application.

The exchange must provide feedback with respect to an application in a timely manner, but not within a specific timeframe. If the exchange rejects an application, the exchange must provide the applicant with the reasons for such rejection. An exchange also may revoke previously granted recognitions.

Recordkeeping

The 2016 Amendment includes recordkeeping provisions that would require an exchange to maintain complete books and records relating to the processing and approval of NEBFH applications. Records to be retained include all information submitted by an applicant to the exchange, all information in connection with the exchange's assessment of an application, and records of oral and written communications between the exchange and the applicant in connection with an application.[6] Such records must be retained until the termination, maturity or expiration date of any recognition and for five years after that date.

Required Reporting

Exchanges must promulgate rules that require applicants that own or control a derivatives position that the exchange has recognized as an NEBFH position to file a report with the exchange, which at a minimum should require an applicant to report when an NEBFH has been established and the applicant's offsetting cash positions.[7] At least quarterly, an exchange must publish on its website

[4] The submission of an application to an exchange under this process and under the processes whereby an exchange exempts a spread position from positions limits or recognizes an enumerated anticipatory bona fide hedging position would not be the only option available to a position holder under the 2016 Amendment. A position holder may also request a no-action letter under CFTC Regulation 140.99 or exemptive relief under Commodity Exchange Act Section 4a(a)(7).

[5] An exchange may establish a separate, streamlined application process for NEBFHs that it has previously recognized.

[6] Although the CFTC has not proposed to require an exchange to record conversations with applicants, the CFTC noted that it would expect an exchange to preserve any written or electronic notes of verbal interactions with such parties.

a description of each type of new derivative position that it has recognized as an NEBFH for the benefit of market participants. The CFTC will review some of these summaries. An exchange must submit weekly reports to the CFTC regarding any position it recognized as an NEBFH in the previous week (including the identity of the applicant and maximum derivative position size recognized) and any revocation or modification of a previously granted recognition. An exchange must submit monthly to the CFTC the reports it receives from market participants detailing positions recognized by the exchange.

Exemption for Certain Spread Positions by an Exchange

The CFTC also proposes to permit exchanges to exempt certain spread transactions from federal positions limits. In order to do so, an exchange must submit implementing rules with the CFTC pursuant to Part 40 of the CFTC's regulations. As with the process to recognize NEBFHs, exchanges that wish to process applications for the exemption of spread positions must meet certain minimum standards. The CFTC anticipates that exchanges may approve exemptions for calendar spreads, quality differential spreads, processing spreads, and product or by-product differential spreads, although the list is not exhaustive. For inter-commodity spreads, in which different components of the spread are traded under different exchanges, a market participant must apply for a spread exemption with each exchange, and an exemption granted by one exchange does not bind the other exchange. Unlike the current rule or the 2013 Proposal, the 2016 Amendment would allow the grant of exemptions for spread positions in the spot month.

Information to be submitted to an exchange by market participants seeking an exemption for a spread position is similar to the information proposed in the NEBFH process, as are the recordkeeping requirements and proposed reporting.

Exchange Recognition of Positions as Enumerated Anticipatory *Bona fide* Hedges

The 2016 Amendment also would allow exchanges to recognize certain enumerated anticipatory *bona fide* hedging positions: (1) hedges of unfilled anticipated requirements; (2) hedges of unsold anticipated production; (3) hedges of anticipated royalties; (4) hedges of services; and (5) cross-commodity hedges. As the hedge positions to be recognized are listed in the 2016 Amendment, the role of the exchange is administrative and the process is simplified as compared to the process to recognize NEBFHs or exempt spread positions. For example, there is no need to establish a bifurcated process to handle applications that deal with novel facts and applications that deal with previously granted recognitions or exemptions. The CFTC also will not require an exchange to post summaries of granted recognitions on its website. Finally, a position holder must file reports that detail its enumerated anticipatory *bona fide* hedging position with the CFTC, with a copy to the exchange that reviewed the position holder's initial application.

CFTC Oversight of Exchanges

The CFTC retains significant powers of review under the 2016 Amendment. The CFTC may review, for any purpose, an application submitted to an exchange by a market participant and all associated records required to be kept by the exchange. If the CFTC undertakes to review a recognition or exemption and determines (1) the position presents novel issues that may take time to review, or (2) the recognition or exemption of a position may be inappropriate, the CFTC will notify the exchange and the applicant and provide 10 business days for the exchange or applicant to furnish additional information. If the CFTC ultimately determines that a recognition or exemption is inappropriate, the CFTC will notify the applicant and provide the applicant a commercially reasonable amount of time to liquidate the derivative position and come into compliance with applicable position limits. The CFTC noted that the determination of a "commercially reasonable amount of time" will be informed by factors such as current market conditions and the protection of price discovery in the market. Nonetheless, in a footnote, the CFTC reaffirmed its previously stated position that it "believes such time period would be less than one business day."[8] The CFTC proposes to delegate certain of its responsibilities to the Director of the Division of Market Oversight, including the decision to review an application at the request of the exchange or at the CFTC's own initiative.

Delay of Exchange-Set Position Limits With Respect to Swaps

Finally, the CFTC proposes to delay the requirement in the 2013 Proposal that exchanges establish and monitor position limits for swaps in the event that an exchange lacks access to sufficient swap position data. The CFTC proposes to delay this requirement as it expects most exchanges do not have sufficient swap position data for a variety of reasons. For example, swaps in a particular

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[7] The CFTC encourages exchanges to establish reporting rules that will allow the exchange to conduct a surveillance program to detect and potentially deter excessively large positions that would have the ability to disrupt the price discovery process.

[8] In addition, an exchange may request that the CFTC consider an application submitted to the exchange, and the CFTC, in its discretion, may agree to do so.

commodity may be traded on several trading facilities or platforms, with the result that no one trading facility or platform has a holistic view of swaps executed involving a particular commodity. Adding to the lack of centralized swap information available to exchanges is the fact that swaps transaction data may currently be reported to any swap data repository, and swaps on physical commodities may be executed other than on a DCM or a SEF. The revised guidance clarifies that an exchange need not establish position limits until the exchange has access to sufficient swap position information, which will occur if, for example, (1) the exchange has access to daily information pertaining to the open swap positions of market participants, or (2) the exchange knows, including through knowledge gained in the surveillance of heavy trading activity occurring on the exchange, that market participants regularly engage in large volumes of speculative trading such that reasonable surveillance personnel would inquire further about the market participant's intentions or open swap positions.

Proposal to Amend the Definition of *Bona fide* Hedging Position

In the 2016 Amendment, the CFTC set forth a definition of *bona fide* hedging position that does not contain the "incidental test" or the "orderly trading requirement," both of which can be found in the current definition[9] and the 2013 Proposal. Through the removal of these two elements, the CFTC seeks to define a *bona fide* hedging position solely in accordance with the elements contained in Section 4a(c)(2) of the CEA. Currently, the incidental test requires that risks offset by a commodity derivative position be incidental to the commercial operations of the position holder, and the orderly trading requirement requires a *bona fide* hedging position to be established and liquidated in an orderly manner consistent with sound commercial practices.

The CFTC notes that the elimination of the incidental test is appropriate because the incidental test is embodied in the economically appropriate test for physical commodities in Section 4a(c)(2) of the CEA.[10] The removal of the orderly trading requirement, is, in the CFTC's view, supported by several factors. First, the CFTC noted that it was not aware that the requirement had ever been utilized to deny the recognition of a *bona fide* hedging position. Second, the CFTC noted that the requirement was unclear in certain contexts, such as when swaps are traded over-the-counter or in off-exchange transactions such as exchange of derivatives for related positions. Third, the CFTC observed that disruptive trading on the part of an entity establishing or liquidating a hedge position would seem to run counter to such entity's economic interests.

The Path Forward

In a statement appended to the 2016 Amendment, CFTC Chairman Timothy Massad emphasized the CFTC's commitment to finalizing the position limits rules by the end of 2016. As discussed in Katten's September 28, 2015 Financial Services Advisory, the CFTC previously proposed an amendment to the 2013 Proposal to permit certain entities within a corporate group to disaggregate positions that are independently controlled when assessing position limits compliance.[11] Two exchanges, the CME Group and ICE Futures US, have adopted provisions that are substantially similar to the CFTC's September 2015 proposal.[12] The CFTC also is currently evaluating exchange estimates of deliverable supply to implement spot month limits based on current data.

The CFTC's proposal is available here.

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9 CFTC Regulation 1.3(z)(1).

10 Commodity Exchange Act, Section 4a(c)(2) (defining a *bona fide* hedging transaction as a transaction or position that is "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise").

11 Aggregation of Positions, 80 Fed. Reg. 58365 (Sept, 29, 2015).

12 *Bridging the Week*, "CME Group Amends Position Limits Aggregation Rules to Conform with Pending CFTC Regulation Change," available here. *Bridging the Week*, "IFUS to Adopt CFTC Proposed Aggregation Rule as Its Own In Advance of CFTC Adoption," available here.