Energy and metals companies and funds beware: Your trading positions may be "limited"

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On January 30, 2020, the Commodity Futures Trading Commission (CFTC) approved on a 3-2 vote proposed rules addressing position limits on speculative derivatives (Position Limits Proposal).[1] The Position Limits Proposal has a 90-day comment period ending on April 29, 2020.

The Position Limits Proposal applies to 25 physically-settled futures contracts and their linked cash-settled futures, options on futures, and "economically equivalent" swaps.[2] Nine of the 25 physically-settled futures contracts are subject to federal position limits under existing law. Of the commodities that would be newly subject to position limits, four are energy contracts and five are metals contracts, so the rule may have a significant impact on energy and metals companies and funds and other traders of such commodities.

The road to the Position Limits Proposal has been a decade in the making. The CFTC first finalized position limits rules in 2011. But in 2012, the U.S. District Court for the District of Columbia vacated most aspects of the final rule.[3] The CFTC proposed position limits regulations again in 2013, and twice more in 2016. None of the three proposals resulted in a final position limits rule, though the CFTC did separately pass amendments to rules governing position aggregation in 2016. The Position Limits Proposal represents a departure from previous efforts by the CFTC to issue rules on position limits. Unlike the CFTC's previous efforts, the Position Limits Proposal includes a meaningful change from the prior proposal in that it requires the CFTC to find that position limits are 'necessary' for any commodity (other than the listed 25) prior to imposing position limits on such commodity.[4]

Energy and metals contracts subject to position limits

The Position Limits Proposal sets spot month limits for five metals contracts[5] and four energy contracts[6] while establishing a conditional spot month limit exemption for certain natural gas

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[1] See https://www.cftc.gov/PressRoom/PressReleases/8112-20.

[2] The Position Limits Proposal puts forth a new definition of "economically equivalent swaps," which would be defined as swaps with "identical material" contractual specifications. Commenters may be interested in asking for more clarity with respect to this definition.

[3] *Int'l Swap Dealers Assoc. v. CFTC*, 887 F.Supp.2d 259, 281 (D.D.C. 2012).

[4] The CFTC's statutory authority to set position limits is at 7 U.S. Code §6a, which states that the CFTC has authority to proclaim and fix position limits "from time to time" "as the Commission finds are necessary to diminish, eliminate, or prevent [excessive speculation]."

[5] The five metals contracts and proposed spot month limits are: COMEX Gold (GC) – 6,000, COMEX Silver (SI) – 3,000, COMEX Copper (HG) – 1,000, NYMEX Platinum (PL) – 500, and NYMEX Palladium (PA) 50.

contracts.[7] The spot month limits for the enumerated energy and metals apply to futures contracts and their "economically equivalent swaps." For non-spot months, the CFTC is not establishing position limits for the five metals contracts and four energy contracts. Instead, the CFTC proposes to require exchanges to set position limits and/or position accountability levels. At first, exchanges would be required to set the non-spot month position limits only for futures and options on futures. Exchanges would be required to set non-spot month position limits for swaps at a later time as determined by the CFTC.

Bona fide hedging exemptions

The Position Limits Proposal aims to curb excessive speculative positions, and as such does not intend to prevent firms from engaging in bona fide hedging activity.[8] To qualify for the bona fide hedging exemption, a position or transaction must: (1) substitute for transactions or positions made at a later time in a physical marketing channel; (2) be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and (3) arise from the potential change in value of actual or anticipated assets, liabilities, or services.

Whether your activity is covered by these exemptions could be a complicated analysis and we anticipate that there will be many comments relating to defining the scope of this exemption further.

The Position Limits Proposal also contains a list of enumerated bona fide hedging exemptions.[9] In addition, the Position Limits Proposal includes guidance on whether and when market participants may measure risk on a gross basis rather than a net basis. Finally, as compared with previous rulemakings the Position Limits Proposal generally narrows a firm's ability to treat positions entered into for "risk management purposes"[10] as bona fide hedges.

Deference to exchanges

In his statement in support of the Position Limits Proposal, Chairman Tarbert noted that historically exchanges have played a significant role in developing position limits.[11] As above, the Position Limits Proposal would seek to leverage existing exchange practices in setting federal position limits. In addition, the Position Limits Proposal would develop a new process, relying heavily on the exchanges, for the CFTC to address requests for bona fide hedging positions that do not fit within the enumerated bona fide hedging exemptions. Exchange approval of an exemption request would satisfy the exemption for *both* exchange-set limits and CFTC-set limits, as long as the CFTC does not object within a ten business day review period (or two business days in the case of sudden or unforeseen scenarios) after the exchange has granted approval of the bona fide hedge with respect to the exchange's limits. The CFTC has specifically requested comment on whether the exchanges should have a role in reviewing non-enumerated bona fide hedge applications for "economically equivalent swaps," (which include OTC swaps) in addition to exchange-traded contracts.

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[6] The four energy contracts and spot month limits are: NYMEX Henry Hub Natural Gas (NG) – 2,000, NYMEX Light Sweet Crude Oil (CL) – 6,000/5,000/4,000, with a step-down depending on the number of days to the last trading day of the contract, NYMEX New York Harbor ULSD Heating Oil (HO) – 2,000, and NYMEX New York Harbor RBOB Gasoline (RB) – 2,000.

[7] The Position Limits Proposal would "allow market participants with cash-settled positions in natural gas to exceed the proposed 2,000 contract spot month limit, provided that the participant exits its spot month positions in the New York Mercantile Exchange ("NYMEX") Henry Hub (NG) physically-settled natural gas contracts, and provided further that the participant's position in cash-settled natural gas contracts does not exceed 10,000 NYMEX Henry Hub Natural Gas (NG) equivalent-size natural gas contracts per DCM that lists a natural gas referenced contract. Such market participants would be permitted to hold an additional 10,000 contracts in cash-settled natural gas economically equivalent swaps."

[8] In Chairman Tarbert's words: "The greatest risk of a position limits rule is that hedgers are caught in the limits aimed at speculators." https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement013020.

[9] See Appendix A to Proposed Part 150.

[10] "Risk management" refers to derivatives positions, typically held by a swap dealer, used to offset a swap position, such as a commodity index swap, with another entity for which that swap is not a bona fide hedge.

[11] https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement013020.

What should we do now?

- Determine which of your trades may be subject to the rule and which may be eligible for the bona fide hedging exemption.

- The CFTC is requesting comments on all aspects of its proposed rulemaking within the 90-day comment period ending on April 29, 2020. If you have significant positions that could be affected by the rule, you may consider submitting a comment letter.

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