If you have questions or would like additional information on the material covered in this Alert, please contact one of the authors:

Peter Y. Malyshev
Partner, Washington, D.C.
+1 202 414 9185
pmalyshev@reedsmith.com

Patricia Dondanville
Partner, Chicago
+1 312 207 3911
pdondanville@reedsmith.com

Kari S. Larsen
Counsel, New York
+1 212 549 4258
klarsen@reedsmith.com

Michael Selig
Associate, Washington, D.C.
+1 202 414 9287
mselig@reedsmith.com

…or the Reed Smith lawyer with whom you regularly work.

U.S. CFTC Approves a Position Limits Reproposal and Finalizes Aggregation Rules

At a Glance…

On December 5, 2016, the U.S.Commodity Futures Trading Commission unanimously approved a Reproposal on Position Limits for Derivatives and a Final Rule on Aggregation of Positions. The Position Limits Reproposal would establish federal speculative position limits for 25 core futures contracts, related futures and exchange-traded options contracts, and economically equivalent swaps. Exchanges would also be permitted to establish speculative position limits that are more (but not less) restrictive than the federal requirements, subject to exchange-granted exemptions that would also be consistent with federal exemptions. The Reproposal includes a revised definition of "*bona fide* hedging position" that addresses some of the concerns raised by commenters, allows the exchanges to grant non-enumerated exemptions (subject, however, to full CFTC review), and more closely conforms to the text of the Commodity Exchange Act, as amended. The 60-day comment period on the Reproposal will begin when it is published in the *Federal Register.*

The Final Rule on Aggregation of Positions, which will take effect 60 days after it is published in the *Federal Register*, will require persons to aggregate for position limits purposes all positions in accounts for which any person, directly or indirectly, (1) controls trading or holds a 10% or greater ownership or equity interest with the positions held and trading done by such person; or (2) holds or controls the trading of positions in more than one account or pool with substantially identical trading strategies. The Aggregation Rule will apply initially to the nine legacy agricultural commodity futures contracts for which federal position limits are currently in place under section 150.2 of the CFTC's regulations. Additionally, if and when the federal speculative position limits rules are finalized,

the Aggregation Rule will apply to the additional 16 core referenced contracts. The Aggregation Rule includes four additional exemptions for: (1) persons with greater than 10% ownership in an entity; (2) where ownership results from broker-dealer activities; (3) underwriting; and (4) arrangements where the sharing of information would violate or create reasonable risk of violating U.S. or foreign law or regulation.

Introduction

On December 5, 2016, the U.S. Commodity Futures Trading Commission (the "CFTC") unanimously approved a Reproposal on Position Limits for Derivatives (the "2016 Reproposal") that would establish federal speculative position limits for 25 core futures contracts, related futures and exchange-traded options contracts, and economically equivalent swaps (collectively, "referenced contracts").[1] The mammoth 910-page proposal revises and updates the previous Proposed Rule on Position Limits for Derivatives[2] issued in December 2013 (the "2013 Proposal"), and the Supplemental Proposed Rule on Position Limits for Derivatives[3] issued in June 2016 (the "Supplemental Proposal"). The 2016 Reproposal also provides the CFTC's summary and responses to comments submitted on the Supplemental Proposal. With the upcoming change in presidential administration, this last aspect of the 2016 Reproposal is useful to gather current thinking on this important topic in light of the significant number of comment letters, new studies, and discussions at CFTC advisory committee meetings over the past three years since the 2013 Proposal. The 2016 Reproposal has already sparked controversy among Democrats in the U.S. Senate, 3 of whom wrote a letter to Chairman Massad admonishing him for failing to finalize the rulemaking in 2016.[4]

As under the 2013 Proposal, the 2016 Reproposal would establish federal spot month and non-spot month limits for each referenced contract, and no person would be allowed to exceed such limits without an exemption.[5] Exchanges would also be permitted to establish speculative position limits that are more (but not less) restrictive than the federal requirements, subject to exchange-granted exemptions that would also be consistent with federal exemptions. The 2016 Reproposal includes a revised definition of "*bona fide* hedging position" that addresses some of the concerns raised by commenters, allows the exchanges to grant non-enumerated exemptions (subject, however, to full CFTC review), and more closely conforms to the text of the Commodity Exchange Act, as amended ("CEA"). The 2016 Reproposal notes that the compliance date for the new position limits requirements, if finalized, would not be earlier than January 3, 2018.

The 60-day comment period on the 2016 Reproposal begins when it is published in the *Federal Register.* The ultimate fate of the CFTC's position limits rulemaking is uncertain with Republicans set to take control of the White House on

January 20, 2017. Commissioner Giancarlo, who is likely to assume the role of Acting Chairman in January, has advocated for "a return to [the CFTC's] traditional approach of principles-based regulation."[6] Although the 2016 Reproposal delegates a degree of flexibility to the exchanges to administer exemptions from the federal position limits regime and estimate deliverable supply, the CFTC would tie exchanges' hands in many respects with prescriptive regulatory requirements. Accordingly, it is possible that this position limits proposal will be followed by another.

Additionally, on December 5, 2016, the CFTC unanimously approved a final rule on the aggregation of positions for assessing compliance with federal speculative position limits rules (the "Aggregation Rule") that will become effective 60 days after it is published in the *Federal Register*.[7] The Aggregation Rule will apply initially to the nine legacy agricultural commodity futures contracts for which federal position limits are currently in place under section 150.2 of the CFTC's regulations ("Legacy Agricultural Contracts"). Additionally, if and when the federal speculative position limits rules are finalized, the Aggregation Rule will apply to the additional referenced contracts. The Aggregation Rule largely adopts the regulations proposed in the Proposed Rule on the Aggregation of Positions,[8] as amended by the 2015 Supplemental Proposal on Aggregation of Positions.[9] The final Aggregation Rule will require persons to aggregate for position limits purposes all positions in accounts for which any person, directly or indirectly, (1) controls trading or holds a 10% or greater ownership or equity interest with the positions held and trading done by such person; or (2) holds or controls the trading of positions in more than one account or pool with substantially identical trading strategies. However, persons may request exemptions from the aggregation requirement by filing a notice with the CFTC in compliance with new section 150.4(c).

The Aggregation Rule includes four additional exemptions for: (1) persons with greater than 10% ownership in an entity (the "Owned Entity Exemption"); (2) where ownership results from broker-dealer activities (the "Broker-Dealer Exemption"); (3) underwriting (the "Underwriting Exemption"); and (4) arrangements where the sharing of information would violate or create reasonable risk of violating U.S. or foreign law or regulation (the "Information Sharing Restriction Exemption"). The Aggregation Rule would also revise the three currently available exemptions for certain FCM accounts (the "FCM Exemption"), accounts carried by an independent account controller[10] (the "Independent Account Controller Exemption"), and pooled accounts (the "Pooled Accounts Exemptions"). Notably, some of the onerous conditions to the exemptions that were contained in the earlier proposals have been withdrawn.

I. Federal Speculative Position Limits

Currently, nine Legacy Agricultural Contracts are subject to federal speculative position limits under Part 150 of the CFTC's regulations. The 2016 Reproposal

would revise Part 150 to establish federal position limits on 25 core referenced futures contracts, including the nine Legacy Agricultural Contracts, and additional agricultural, energy and metals contracts.[11] The CFTC's reproposed definition of "referenced contract" includes the 25 core referenced contracts, related futures and exchange-traded options contracts, and economically equivalent swaps, but excludes basis contracts, guarantees of a swap, location basis contracts, commodity index contracts, and trade options meeting the requirements of section 32.3 of the CFTC's regulations. The CFTC would establish position limits no less frequently than every two calendar years.

The position limits for the spot month would differ from the limits applicable for for single-month and all-months combined (collectively, "non-spot month"). The limit for spot months would be set at 25% of deliverable supply, as estimated by the CFTC or by the relevant designated contract market ("DCM") and verified by the CFTC, or at a lower percentage recommended by the DCM. The CFTC noted that guidance for calculating deliverable supply is in Appendix C to Part 38 of the CFTC's regulations (Designated Contract Markets). It declined to revise the guidance, but explained that deliverable supply estimates are based on "what can reasonably be expected to be readily available." The non-spot month limits would be calculated using the formula of 10% of the open interest for the first 25,000 contracts and 2.5% of the open interest thereafter (the "10%, 2.5% Formula"), based on open interest in physical commodity futures and options data from the relevant exchanges and adjusted Part 20 swap position data. However, the CFTC proposes to maintain the current level of 12,000 contracts for CBOT KC HRW Wheat and MGEX Hard Red Spring Wheat.[12]

II. Exemptions from Federal Speculative Position Limits

The 2016 Reproposal would provide exemptions for: (1) enumerated *bona fide* hedging positions; (2) certain anticipatory hedging and spread positions that are approved by a DCM or swap execution facility ("SEF") in accordance with reproposed Part 150; (3) financial distress positions; (4) conditional spot month limit positions in natural gas only (rather than for all commodities as previously proposed); (5) pre-enactment and transition period swaps; (6) certain non-enumerated hedging positions that are approved by a DCM or SEF in accordance with reproposed Part 150; and (7) swap risk management positions, where the CFTC previously granted an exemption under section 1.47 of the CFTC's regulations. The 2016 Reproposal expressly provides that commodity trade options meeting the requirements of section 32.3 of the CFTC's regulations and locational basis contracts are not considered to be referenced contracts, and that a commodity trade option, in fact, may be considered as part of the cash commodity being hedged, provided that the option is adjusted on a futures-equivalent basis. The 2016 Reproposal would eliminate the spread exemption currently in section 150.3 and move the current Independent Account Controller exemption into section 150.4 (Aggregation of Positions).

The 2016 Reproposal includes a revised definition of *bona fide* hedging position that largely mirrors the Supplemental Proposal and eliminates the "incidental test" and "orderly trading requirement" from the 2013 Proposal. The incidental test would have expressly required that the purpose of the relevant *bona fide* hedging position was to reduce commodity price risk, while the orderly trading requirement would have required that the relevant position was established and liquidated in an orderly manner in accordance with sound commercial practices. The requirements were generally objected to by commenters following the 2013 Proposal.

Under the 2016 Reproposal, a *bona fide* hedging position in an excluded commodity (i.e., financial instrument) must: (1) pass the "economically appropriate test" (i.e., be "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise"); and (2) be specifically enumerated in the CFTC's *bona fide* hedging definition or be recognized as a *bona fide* hedging position by a DCM or SEF. A DCM or SEF may recognize risk management exemptions in an excluded commodity, irrespective of the economically appropriate test. Given that the 2016 Reproposal would not impose federal position limits on excluded commodities, these provisions only pertain to exchange-set limits.

A *bona fide* hedging position in a physical commodity must: (1) pass the economically appropriate test; (2) pass the "temporary substitute test" (i.e., represent "a substitute for transactions made or to be made or positions taken or to be taken at a later time in the physical marketing channel"); (3) meet the "change in value requirement" (i.e., arise "from the potential change in the value of assets, liabilities, or services, whether current or anticipated"); and (4) be specifically enumerated in the CFTC's *bona fide* hedging definition or be recognized as a *bona fide* hedging position by a DCM or SEF. The 2016 Reproposal notes that, despite elimination of the "incidental test," the CFTC construes the term "risks" in the context of the economically appropriate test to encompass price risk in the conduct and management of a commercial enterprise, but not other commercial or operational risks. Commercial energy companies consistently raised concerns regarding this interpretation at CFTC Energy and Environmental Markets Advisory Committee ("EEMAC") meetings, but the 2016 Reproposal does not reference those comments or address those concerns. The CFTC would recognize pass-through swap offsets and pass-through swaps as a *bona fide* hedging positions.

All persons who claim an exemption must maintain complete books and records concerning all details of their related cash, forward, futures, options, and swap positions and transactions pursuant to reproposed section 150.3(g). This would include trade options even though they are excluded from the definition of "referenced contract." Such persons must also make their books and records available to the CFTC upon request.

III. Exchange-Set Limits and Exemptions

The CFTC proposed regulations governing exchange-set limits that largely mirror the 2013 Proposal, as revised by the Supplemental Proposal in terms of the authority of the exchanges. The 2016 Reproposal permits DCMs and SEFs to adopt lower (more restrictive) position limits for a referenced contract. It also includes acceptable practices for setting exchange position limits and accountability levels in other listed contracts.

DCMs and SEFs may grant non-enumerated *bona fide* hedging exemptions for positions that meet the general definition of "*bona fide* hedging position" in proposed section 150.1. However, the CFTC may review the exemptions *de novo* and reject the exchange's decision, disallowing the exchange-granted exemption and requiring the position holder to liquidate such position within "a commercially reasonable" timeframe (which the CFTC notes would typically be less than 24 hours, another interpretation that commercial energy companies objected to at CFTC EEMAC Meetings). In order to recognize a non-enumerated *bona fide* hedging position, the exchange must have at least one year of experience overseeing exchange-set position limits in an actively traded referenced contract for a particular commodity. DCMs and SEFs would also be permitted to grant spread exemptions and would no longer be prohibited from recognizing spreads during the spot month.

Exchanges that elect to process non-enumerated *bona fide* hedging exemptions would also be subject to recordkeeping and reporting requirements. The CFTC again proposed to delay any requirement for exchanges to establish and monitor position limits on swaps to the extent such exchange lacks access to sufficient swap position information.

The 2016 Reproposal does not explain how the CFTC itself will monitor position limits on swaps, particularly in light of the lack of reliable swap transaction data for such categories of swaps currently reporting to swap data repositories.[13] Nevertheless, each trader would be required to establish policies and procedures for tracking its futures and swaps positions (and those over which it exercises control) across all of its trading platforms and trading desks in the U.S. and overseas.

IV. Series '04 Reporting Forms and Reporting Requirements

The 2016 Reproposal would require all Series '04 Reporting Forms to be filed with the CFTC electronically. Additionally, it would revise and broaden the scope of the Series '04 forms that persons holding *bona fide* hedging positions and merchants and dealers in cotton holding or controlling reportable positions for future delivery in cotton must submit pursuant to Part 19 of the CFTC's regulations, namely Form 204 (Statement of Cash Positions in Grains, Soybean Oil and Soybean Meal) and Form 304 (Statement of Cash Positions in Cotton). All persons who wish to apply for an exemption from federal position limits would be required to submit a Form 204, which would be renamed "The Statement of Cash Positions for Hedgers."

The 2016 Reproposal would also establish three new Series ’04 Reporting Forms: (1) reproposed Form 504 would be required for persons claiming the conditional spot-month limit exemption for natural gas commodity derivative contracts; (2) reproposed Form 604 would be required for persons claiming a *bona fide* hedging position exemption for either of two specific pass-through swap position types; and (3) reproposed Form 704 would be required for persons claiming a *bona fide* hedging exemption for certain anticipatory *bona fide* hedging positions.

V. Aggregation of Positions

With respect to the nine Legacy Agricultural Contracts for which federal position limits are currently in place under Part 150 of the CFTC’s regulations (and all of the referenced contracts, if the 2016 Reproposal or another iteration of the federal speculative position limits is finalized), persons are required to aggregate for position limits purposes all positions in accounts for which any person, directly or indirectly, (1) controls trading or holds a 10% or greater ownership or equity interest with the positions held and trading done by such person; or (2) holds or controls the trading of positions in more than one account or pool with substantially identical trading strategies. The final Aggregation Rule unanimously approved by the CFTC on December 5, 2016, will go into effect 60 days after it is published in the *Federal Register*, revising the current aggregation provisions in section 150.4 and adding four new exemptions from the aggregation requirements.

Persons will now be required to submit a notice filing to the CFTC pursuant to section 150.4(c) of the CFTC’s regulations to request any exemption from the aggregation requirement, including the three exemptions currently available. Therefore, market participants that are currently relying on the FCM Exemption, the Pooled Accounts Exemption, or the Independent Account Controller Exemption must submit a notice filing within 60 days of the Aggregation Rule’s publication in the *Federal Register* to maintain their exemption. The notice filing is effective upon submission to the CFTC, but the CFTC may call for additional information, request amendment, terminate, or otherwise modify the person’s aggregation exemption. Filers must amend the notice and re-submit if there is a material change in circumstances. If the notice is not timely submitted, that will constitute a violation of section 150.4(c), but not a position limits violation if the submission was made five business days after the filer was aware, or should have been aware, that the notice was not timely filed.

Persons with greater than 10% ownership in an owned entity may now rely on the Owned Entity Exemption by submitting a notice filing and demonstrating compliance with a list of conditions set forth in section 150.4(b)(2)(i). The owner and owned entity must demonstrate that they: (1) do not have knowledge of the trading decisions of the other; (2) trade pursuant to separately developed trading systems;

(3) have and enforce written procedures to preclude each from having knowledge of, gaining access to, or receiving data about, trades of the other; (3) do not share employees that control the trading decisions of either; and (4) do not have risk management systems that permit the sharing of its trades or its trading strategy with employees that control the trading decisions of the other. The Aggregation Rule also provides new exemptions for broker-dealer activity, underwriting, and where information sharing associated with aggregation would create a reasonable risk of either person violating U.S. or foreign law or regulations.

VI. The Next Chapter

The CFTC has now issued several sets of proposed rules since the *ISDA v. CFTC*[14] decision invalidated its first attempt to implement its Dodd-Frank Act authority to impose position limits under revised CEA section 4a(a). Moreover, there is reason to wonder whether Commissioner Giancarlo and a Republican-led CFTC will propose yet another sequel in the ongoing position limits saga or finalize the rulemaking in 2017. Chairman Massad described the 2016 Reproposal as a compromise in a "time of transition."[15] With the threat of Congressional Review Act,[16] which would allow Congress to strike down a final position limits rule, looming large, and House Republicans making their thoughts abundantly clear on the subject of repealing or substantially revising the Dodd-Frank Act, the Commissioners decided once again to put the position limits rulemaking out for public comment, largely as previously proposed. Commissioner Giancarlo stated that he believes the 2016 Reproposal "provides the basis for the implementation of a final position limits rule that [he] could support."[17] However, the question remains whether the 2016 Reproposal is the last stepping stone or a new starting point to a final rule.

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1. The 2016 Reproposal is available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/federalregister120516.pdf.

2. *Position Limits for Derivatives; Proposed Rule*, 78 Fed. Reg. 75,680 (Dec. 12, 2013).

3. *Position Limits for Derivatives: Certain Exemptions and Guidance; Proposed Rule*, 81 Fed. Reg. 38,458 (June 13, 2016).

4. On December 14, 2016, Democratic Senators Maria Cantwell, Sherrod Brown, and Dianne Feinstein sent a letter to the CFTC Chairman Massad stating that they are "disturbed by the CFTC's action to delay [the position limits] rulemaking and [Chairman Massad's] inability to guide the rule to completion in the two and a half years of [his] tenure." The Senators urged Chairman Massad "to spend [his] remaining time putting the CFTC in a position to finalize strong Dodd-Frank rules for the derivatives market as contemplated by Congress." The letter is available at https://www.cantwell.senate.gov/news/press-releases/cantwell-brown-feinstein-blast-cftc-for-failure-to-finish-rule-to-curb-excessive-speculation-in-commodities.

5. The 2016 Reproposal would not prescribe federal position accountability levels for these products.

6. *Address of CFTC Commissioner J. Christopher Giancarlo to the American Enterprise Institute*, Sep. 21, 2016, *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-17.

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7. The Aggregation Rule is available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/federalregister120516a.pdf.

8. *Aggregation of Positions; Proposed Rule,* 78 Fed. Reg. 68,946 (Nov. 15, 2013).

9. *Aggregation of Positions; Supplemental Notice of Proposed Rulemaking,* 80 Fed. Reg. 58,365 (Sep. 29, 2015).

10. This exemption is currently within § 150.3, but the Aggregation Rule moves it into § 150.4.

11. The CFTC proposes to defer action on three of the original 28 core referenced futures contracts originally proposed in the 2013 Proposal (CME Class III Milk, CME Feeder Cattle, and CME Lean Hogs). Position limits would apply to the following agricultural, energy and metals contracts:

    (1) Legacy Agricultural Contracts: CBOT Corn, CBOT Oats, CBOT Soybeans, CBOT Soybean Meal, CBOT Soybean Oil, CBOT Wheat, CBOT KC HRW Wheat, MGEX Hard Red Spring Wheat, ICE Futures U.S. Cotton No. 2;

    (2) Other Agricultural Contracts: CBOT Rough Rice, ICE Futures U.S. Cocoa, ICE Futures U.S. Coffee C, ICE Futures U.S. FCOJ-A, ICE Futures U.S. Sugar No. 11, ICE Futures U.S. Sugar No. 16, CME Live Cattle;

    (3) Energy: NYMEX Henry Hub Natural Gas, NYMEX Light Sweet Crude Oil, NYMEX NY Harbor ULSD, NYMEX RBOB Gasoline; and

    (4) Metals: COMEX Gold, COMEX Silver, COMEX Copper, NYMEX Platinum, NYMEX Palladium.

12. There was considerable discussion about the appropriateness of using a percentage of deliverable supply and how to calculate deliverable supply for various energy commodities at the EEMAC meetings in July 29, 2015 and February 25, 2016. That discussion is not reflected in the summary of submitted comments discussed in the 2016 Reproposal.

13. *See Swap Dealer De Minimis Exception Final Report,* Aug. 15, 2016, *available at* http://www.cftc.gov/idc/groups/public/@swaps/documents/file/dfreport_sddeminis081516.pdf.

14. *See Int'l Swaps and Derivatives Ass'n v. U.S. Commodity Futures Trading Comm'n*, 887 F. Supp. 2d 259 (D.D.C. 2012).

15. *Statement of Chairman Timothy Massad Regarding Proposed Rule on Position Limits for Derivatives,* Dec. 5, 2016, available at http://www.cftc.gov/PressRoom/SpeechesTestimony/massadstatement120516.

16. 5 U.S.C. § 801-808 (2016).

17. *Statement of Commissioner J. Christopher Giancarlo on Proposed Rule for Position Limits for Derivatives*, Dec. 5, 2016, available at http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement120516.

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