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## *CFTC Approves New Proposed Position Limits Rule*

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At a January 30, 2020 open meeting, the Commodity Futures Trading Commission (“CFTC” or “Commission”) narrowly approved, by a 3-2 vote, a proposal for amended regulations on speculative position limits (the “Proposed Rule”),<sup>1</sup> with the aim of implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”) requirement that the CFTC establish position limits “necessary” for “diminishing, eliminating, or preventing” excessive speculation that causes “sudden or unreasonable fluctuations or unwarranted changes in . . . price . . . .”<sup>2</sup> The Proposed Rule is the Commission’s fifth attempt at proposing position limits rules spanning across nearly a decade; the Commission first proposed its final position limit rules in 2011 (which the U.S. District Court for the District of Columbia subsequently vacated in 2012),<sup>3</sup> proposed rules again in 2013, supplemented by a proposal in June 2016, then proposed rules again in December 2016.<sup>4</sup>

### **I. Key Aspects of the Proposed Rule**

#### **A. Expansion of Contracts Subject to Federal Position Limits**

Currently, nine agricultural commodity futures contracts are subject to position limits (the “Legacy Contracts”).<sup>5</sup> The Proposed Rule would expand this number to twenty-five,<sup>6</sup> and also would apply position limits to futures and options that are directly or indirectly linked to these twenty-five contracts, along with “economically equivalent swaps”—swaps with “identical material” contractual specifications, terms, and conditions to a referenced contract (collectively, the “Referenced Contracts”).<sup>7</sup> According to the CFTC, establishing position limits for the Referenced Contracts is important for several reasons, including the fact that these contracts require physical delivery of the underlying commodities, some of which bear heightened importance to the national economy and would impose severe economic burdens if subject to excessive speculation. Further, the relatively narrow scope of the proposed definition of “economically equivalent swaps” could help “prevent regulatory arbitrage and would strengthen international comity,” in that it would not prompt U.S.-based swaps activity to potentially migrate to other jurisdictions, given the similarity in the relevant definitions, such as with the definition used in the European Union (“EU”).<sup>8</sup> This also may help to reduce compliance costs for U.S. and EU market participants, who may find the proposed definition familiar and “already have systems and personnel in place to identify and monitor such swaps.”<sup>9</sup>



## **B. Delegating to Exchanges on Non-Spot Months and Netting**

While the Proposed Rule applies the federal spot month limit of 25% of commodity deliverable supply to all twenty-five Referenced Contracts, federal limits outside the spot month would apply only to the nine Legacy Contracts subject to existing federal limits. The remaining sixteen Referenced Contracts would be subject only to exchange-set limits and/or position accountability levels on non-spot months. Exchange-set limits must be calibrated to reduce any potential threat of market manipulation of the contract's/underlying commodity's price or index. The proposed spot month limits will apply separately to physically-settled and cash-settled Referenced Contracts, thus allowing netting only among physically- or cash-settled contracts but not across the two types of contracts.

## **C. Revised Definition of "Bona Fide Hedging"**

Under Section 4a(c)(1) of the CEA, position limits do not apply to transactions or positions that are "shown to be bona fide hedging transactions or positions."<sup>10</sup> The Proposed Rule would revise the CFTC's current definition of "bona fide hedging," which the CFTC considers outdated and unreflective of today's commercial hedging practices for commodities such as metal and energy, which were not subject to federal position limits when the CFTC originally developed the current bona fide hedging definition. Accordingly, the Proposed Rule purports to define "bona fide hedging" in a way that accommodates changing hedging practices over time and provides an expanded list of enumerated bona fide hedges.<sup>11</sup>

The Proposed Rule seeks to maintain the general elements currently found in the existing bona fide hedging definition that conform to Dodd-Frank's revised statutory bona fide hedging definition in CEA Section 4a(c)(2), and proposes to eliminate the elements that do not. More specifically, the Proposed Rule modifies the "temporary substitute test," the "economically appropriate test," and the "change in value requirement," and eliminates the "incidental test" and the "orderly trading requirement," which are not reflected in the revised statutory text in the CEA.<sup>12</sup> The Proposed Rule also updates the "temporary substitute test" to require that a bona fide hedging transaction or position in a physical commodity "always," and not just "normally," be connected to the production, sale, or use of a physical cash-market commodity.<sup>13</sup> Consequently, subject to certain exceptions, the Proposed Rule no longer allows traders to deem positions entered into for risk management purposes as bona fide hedges. The CFTC believes that harmonizing its rules with the CEA will reduce uncertainty and enable exchanges, market participants, and the Commission itself to more easily discern whether novel trading practices qualify as bona fide hedges.

## **D. Streamlined Approach to Non-Enumerated Hedge Exemptions**

Under the Proposed Rule, traders of any of the Referenced Contracts who invoke one of the enumerated hedges mentioned above need only receive an exemption from an exchange before beginning to hedge; they would no longer need to file Form 204s or 304s with the CFTC on a monthly basis to demonstrate the cash-market position justifying position limit overages.

The Proposed Rule also eases the hedge exemption process for traders seeking to obtain a non-enumerated hedge exemption. Under this streamlined process, traders would be able to apply directly to exchanges for an exemption. Once the exchange grants the approval, the CFTC would have only ten business days (or two business days in limited instances) to reverse the exchange's decision, and reversal of an exchange's decision would require formal CFTC action. When granting exemptions, the exchanges must consider whether an exemption would result in a position that would not be in accord with "sound commercial practices" in the relevant market, or would "exceed an amount that may be



established and liquidated in an orderly fashion in that market.”<sup>14</sup> The CFTC proposed these simplifications in part to leverage exchange expertise and resources, while affording the Commission the opportunity to intervene as necessary.

## ***E. Rules on Aggregation***

In 2016, the CFTC adopted final aggregation rules for contracts subject to federal limits, which currently apply only to the Legacy Contracts and would apply to the Referenced Contracts under the Proposed Rule.<sup>15</sup> The CFTC acknowledged in the Proposed Rule that, for contracts not subject to federal limits, traders may be burdened if different exchanges were to adopt different aggregation standards. Accordingly, under the Proposed Rule, all designated contract markets, and, ultimately, swap execution facilities, that list physical commodity derivatives, regardless of whether the contract is subject to federal limits, would be required to adopt aggregation rules for such contracts that conform to the CFTC’s aggregation rules. Such exchange-set aggregation rules would be applicable to the exchange-set limits, which the Proposed Rule also would require. Exchanges that list excluded commodities also are encouraged to adopt aggregation rules that conform to the CFTC’s aggregation rules. The Commission explained that aggregation “policies that otherwise vary from exchange to exchange would increase the administrative burden on a trader active on multiple exchanges,” and also would increase the “administrative burden on the Commission in monitoring and enforcing exchange-set position limits.”<sup>16</sup>

## ***F. Necessity Finding***

Unlike the Commission’s prior proposals, the Proposed Rule interprets the relevant statutory language providing that position limits be established only “as the Commission finds are necessary.”<sup>17</sup> This is contrary to the Commission’s prior position that CEA Section 4a required it to establish position limits even in the absence of finding that the limits were “necessary.”<sup>18</sup> Based on this interpretation, the Proposed Rule establishes limits on a limited set of commodities for which the CFTC preliminarily found speculative position limits necessary based on factors such as the particular importance of the Referenced Contracts in the price discovery process for their underlying commodities and the acute economic burdens on interstate commerce that would arise from excessive speculation, among others.<sup>19</sup>

## **II. Chairman Tarbert’s Statement in Support of the Proposed Rule**

In his statement supporting the Proposed Rule, CFTC Chairman Heath P. Tarbert emphasized that the Proposed Rule will “protect Americans from some of the most nefarious machinations in our derivatives market” and help ensure that market prices “reflect real supply and demand.”<sup>20</sup> Chairman Tarbert explained that the CFTC expanded the number of contracts subject to federal position limits to cover all instances in which the disruption of a commodity’s distribution would have a “significant impact” on the U.S. economy.<sup>21</sup> At the same time, Chairman Tarbert noted that the expanded definition of bona fide hedging and the streamlined processes for obtaining hedging exemptions ensure access for bona fide hedgers, so as to not disrupt the “regulatory experience of American producers, middlemen, and end-users of commodities.”<sup>22</sup>

## **III. Commissioner Stump’s Statement in Support of the Proposed Rule**

While acknowledging that the Proposed Rule is not perfect, Commissioner Dawn Stump supported the publication of the Proposed Rule and called it “[r]easonably designed,” “[b]alanced in its approach,” and “workable in practice.”<sup>23</sup> She then identified the two particular areas of the Proposed Rule she believes can be improved: (1) the list of enumerated hedging transactions and positions, and (2) the



review process for non-enumerated hedging practices. Additionally, in addressing the issue of “necessity finding,” Commissioner Stump emphasized statutory analysis, explaining that subsections (1) and (2) of CEA Section 4a(a) (i.e., the statutory provisions relating to the CFTC’s mandate of imposing position limits) are linked and should not be viewed in isolation.<sup>24</sup>

#### **IV. Commissioners Behnam’s and Berkovitz’s Dissenting Statements**

CFTC Commissioners Rostin Behnam and Dan Berkovitz cast the two votes against the Proposed Rule. In his dissenting opinion, Commissioner Behnam decried the Proposed Rule’s deference to the exchanges and their authority to establish position limits or accountability levels on non-spot months for sixteen of the twenty-five Referenced Contracts<sup>25</sup> and faulted the majority for failing to explain how the effectiveness of exchange-set limits would compare to that of federal position limits, “which among other things, must apply in the aggregate as mandated by CEA section 4a(a)(6).”<sup>26</sup> He further criticized the CFTC’s proposal to rely on exchanges to collect and hold “relevant cash market data for the Commission’s use only after requesting it,” a “careless” choice that contravenes congressional intent.<sup>27</sup>

Commissioner Berkovitz leveled similar critiques of the Proposed Rule, urging the CFTC to recognize bona fide hedge exemptions “in its own rules through prospective, notice and comment rulemaking, [and] not delegate these determinations to the exchanges”<sup>28</sup> and questioning the decision to refrain from adopting non-spot month limits for sixteen commodities. Additionally, he raised concerns that the Proposed Rule would abruptly increase position limits in many physical delivery agricultural, metals, and energy commodities in spot and individual non-spot months, in some instances to multiples of their current levels, with no opportunity for the Commission to monitor for or guard against adverse impacts to preserve market integrity.<sup>29</sup>

#### **V. Conclusion**

The Commission has asked market participants to submit comments on the Proposed Rule by April 29, 2020. The CFTC invites comments on any aspect of the Proposed Rule explained above, or otherwise. The Proposed Rule likely will be amended further before finalization, and Commissioner Stump’s position may well provide the middle ground around which a majority of the Commissioners coalesce. Compromises on other issues likely will occur as well.

Market participants that could be affected by the Proposed Rule are encouraged to comply with the Commission’s request for comments and should consider enlisting counsel to assist with the comment process. Experienced counsel also can help market participants navigate the new requirements and procedures that would result from formal adoption of the Proposed Rule.





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<sup>1</sup> Position Limits for Derivatives (proposed Jan. 30, 2020) (publication in *Federal Register* pending) (to be codified at 40 C.F.R. pts. 1, 15, 17, 19, 40, 140, 150, 151), <https://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/PositionLimitsforDerivatives/index.htm> [hereinafter "Proposed Rule"].

<sup>2</sup> 7 U.S.C. § 6a(a)(1).

<sup>3</sup> *Int'l Swaps & Derivatives Ass'n v. CFTC*, 887 F. Supp. 2d 259 (D.D.C. 2012).

<sup>4</sup> Position Limits for Derivatives, 76 Fed. Reg. 4752 (Jan. 26, 2011); Position Limits for Derivatives, 78 Fed. Reg. 75,680 (Dec. 12, 2013); Position Limits for Derivatives: Certain Exemptions and Guidance, 81 Fed. Reg. 38,458 (June 13, 2016); Position Limits for Derivatives, 81 Fed. Reg. 96,704 (Dec. 30, 2016).

<sup>5</sup> These nine "legacy" contracts are: CBOT Corn, CBOT Oats, CBOT Soybeans, CBOT Wheat, CBOT Soybean Oil, CBOT Soybean Meal, MGEX Hard Red Spring Wheat, ICE Cotton No. 2, and CBOT KC Hard Red Winter Wheat.

<sup>6</sup> See Proposed Rule at 11. The additional sixteen contracts subject to federal position limits under the Proposed Rule are: CBOT Rough Rice, ICE Cocoa, ICE Coffee C, ICE FCOJ-A, ICE U.S. Sugar No. 11, ICE U.S. Sugar No. 16, CME Live Cattle, COMEX Gold, COMEX Silver, COMEX Copper, NYMEX Platinum, NYMEX Palladium, NYMEX Henry Hub Natural Gas, NYMEX Light Sweet Crude Oil, NYMEX New York Harbor ULSD Heating Oil, and NYMEX New York Harbor RBOB Gasoline. See *id.*

<sup>7</sup> *Id.* at 11-12, 75.

<sup>8</sup> *Id.* at 76; see *id.* at 318. This, in turn, would further statutory goals, including those set forth in Commodity Exchange Act ("CEA") Section 4a(a)(2)(C), which requires the Commission to "strive to ensure" that federal position limits are "comparable" to those of foreign exchanges and will not cause "price discovery . . . to shift to trading" on those exchanges. *Id.* at 76.

<sup>9</sup> *Id.* at 76-77.

<sup>10</sup> 7 U.S.C. § 6a(c)(1).

<sup>11</sup> The list, detailed in Appendix A to Part 150, enumerates the following eleven hedge exemptions: hedges of unsold anticipated production, hedges of offsetting unfixed-price cash commodity sales and purchases, hedges of anticipated mineral royalties, hedges of anticipated services, cross-commodity hedges, hedges of inventory and cash commodity fixed-price purchase contracts, hedges of cash commodity fixed-price sales contracts, hedges by agents, offsets of commodity trade options, hedges of unfilled anticipated requirements, and hedges of anticipated merchandising. See Proposed Rule at 479-82.

<sup>12</sup> *Id.* at 32.

<sup>13</sup> *Id.* at 19 (emphases in original).

<sup>14</sup> *Id.* at 16.

<sup>15</sup> The Proposed Rule does not amend the CFTC's existing rule for aggregation of positions for purposes of compliance with federal position limits.

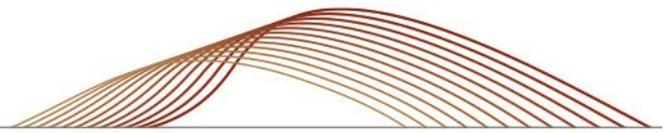
<sup>16</sup> *Id.* at 194.

<sup>17</sup> *Id.* at 235.

<sup>18</sup> *Id.* at 231.

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<sup>19</sup> *Id.* at 9.

<sup>20</sup> CFTC, Statement of Chairman Heath P. Tarbert in Support of Proposed Rule on Speculative Position Limits (Jan. 30, 2020), <https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement013020>.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> CFTC, Statement of Commissioner Dawn D. Stump Regarding Proposed Rule: Position Limits for Derivatives (Jan. 30, 2020), <https://www.cftc.gov/PressRoom/SpeechesTestimony/stumpstatement013020>.

<sup>24</sup> Commissioner Stump's statement provides an infographic titled "Commodity Exchange Act §4a(a): Finding Position Limits Necessary is a Prerequisite to the Mandate for Establishing Such," which further explains her statutory analysis on this point. *See id.*

<sup>25</sup> CFTC, Statement of Dissent by Commissioner Rostin Behnam Regarding Position Limits for Derivatives; Proposed Rule (Jan. 30, 2020), <https://cftc.gov/PressRoom/SpeechesTestimony/behnamstatement013020>.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> CFTC, Dissenting Statement of Commissioner Dan M. Berkovitz Regarding Proposed Rule on Position Limits for Derivatives (Jan. 30, 2020), <https://cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement013020b>.

<sup>29</sup> *Id.*