CLEARY GOTTLIEB Alert Memo

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CFTC Proposes New Federal Position Limits and Exemptions for Certain Energy Commodity Contracts

On January 26, 2010, the U.S. Commodity Futures Trading Commission ("CFTC" or the "Commission") issued a notice of proposed rulemaking (the "Notice of Proposed Rulemaking")[1] in which it proposes federal spot month, single-month and all-months-combined ("AMC") position limits for specific natural gas, crude oil, heating oil and gasoline futures and option contracts (the "Proposed Regulations"). In addition to market specific limits, the Proposed Regulations would aggregate and apply limits across all exchanges listing economically similar contracts as well as all exempt commercial markets ("ECMs")[2] that are registered entities with respect to such contracts. According to the Commission, it does not intend for its proposed position limits to replace the limits and accountability levels already set by U.S. futures exchanges, but rather to serve as the "outer bound" in order to prevent an individual trader's speculative positions from causing sudden or unreasonable fluctuations or unwarranted changes in the price of any of the enumerated energy commodities.

While the Proposed Regulations would not directly modify or restrict existing exchange limits,[3] it should be noted that, by establishing an independent and superseding federal position limit framework, the Commission would, by design, potentially limit positions that are currently permitted under exchange-administered position limit and accountability standards, particularly in the case of swap dealers[4] and participants relying on

[1] 75 FR 4144 (January 26, 2010).

[2] ECMs are markets relying on the exemption contained in Commodity Exchange Act ("CEA") § 2(h)(3).

[3] As a result, by way of example, index trackers would not be restricted from continuing to rely on existing exchange risk management exemptions until their positions reach the higher level of the proposed new federal position limits, at which point they would not be eligible for any federal position limit exemption under the Proposed Regulations.

[4] Significantly, swap dealers hedging over-the-counter ("OTC") swap positions would be subject to a hard cap of twice the proposed federal position limit and would not be eligible for additional hedge or risk management exemptions even where their swap counterparties are entering into the swaps for hedging or risk management purposes. In contrast, the U.S. House of Representatives' Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173) would not subject swap dealers to a hard cap on the positions they may hold pursuant to a risk management exemption, but would provide that in order qualify for such exemption, a swap position

risk management exemptions, in addition to conventional *bona fide* hedgers. The Commission is also proposing to use (consistent with current exchange requirements) non-spot month limits based on the level of open interest in the relevant contract (in contrast to spot month limits that would be based on deliverable supply), an approach that, together with the proposed restrictions on available position limit exemptions, could result in potentially significant additional quantitative constraints on positions, particularly in newer contracts and otherwise less liquid contracts and contract months.

Notwithstanding the potential of the Proposed Regulations to impose additional significant constraints on the size of futures positions, the Commission notes that the specific quantitative levels that have been proposed would, as a practical matter, limit the positions of only a small number of existing traders.

The Commission would also alter the methodology by which positions are aggregated for purposes of applying the proposed federal position limits. Specifically, the Proposed Regulations would prohibit disaggregation of positions controlled by "independent account controllers". It would additionally modify the reporting and other requirements associated with the proposed federal position limits and exemptions.

Notably, the Proposed Regulations would impose limits on the aggregate positions of market participants without regard to whether, or the extent to which, such positions are speculative. As a result, there is a significant question as to whether the Proposed Regulations exceed the Commission's authority under the Commodity Exchange Act ("CEA"), which, as the Commission itself recites in the Notice of Proposed Rulemaking, authorizes it to impose position limits for the purpose of preventing excessive speculation.

The comment period for the Notice of Proposed Rulemaking will end on April 26, 2010, 90 days after publication in the Federal Register.

Key elements of the proposal are summarized below.

I. Background.

The Notice of Proposed Rulemaking is the latest in a series of recent actions taken by the Commission and by Congress in response to recent increases and volatility in energy prices and concerns regarding excessive speculation in the energy markets. In 2008, Congress adopted the CFTC Reauthorization Act of 2008,[5] which, in relevant part, amended the CEA to require ECMs, like U.S. futures exchanges, to adopt, where necessary and

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hedged by futures must be executed opposite a counterparty that is itself hedging a commercial risk under the narrow definition of *bona fide* hedging included in the bill.

[5] Food, Conservation and Energy Act of 2008, Pub. L. No. 110-246, 122 Stat. 1624 (June 18, 2008).

appropriate, speculative position limits or accountability levels for "significant price discovery contracts" ("SPDCs") and also gave the Commission direct authority to set speculative position limits for SPDCs listed on ECMs.[6] To-date, only ICE's Henry Hub Financial LD1 Fixed Price natural gas contract has been classified as an ECM-SPDC by the Commission.[7]

In March of 2009, the Commission issued a concept release in which it solicited comments on eliminating the *bona fide* hedge exemption for swap dealers and replacing it with a conditional limited risk management exemption (the "Concept Release").[8] Subsequently, in July and August of 2009, the Commission held a series of hearings in which it explored, among other issues, whether it should directly set speculative position limits for energy contracts, the authority to establish such limits having been historically delegated by the Commission to U.S. futures exchanges. Like the Concept Release, the energy hearings also explored whether to eliminate or limit the hedge exemptions available to swap dealers.

Most recently, the U.S. House of Representatives passed H.R. 4173, the Wall Street Reform and Consumer Protection Act of 2009. Similar to the Notice of Proposed Rulemaking, H.R. 4173 would require that the Commission, rather than U.S. futures exchanges, directly set speculative position limits for futures and option contracts on physical commodities, including energy, and limit the availability of exemptions from such CFTC-prescribed limits for risk management positions held by swap dealers. H.R. 4173 would also greatly expand the Commission's authority to regulate over-the-counter ("OTC") derivatives and contracts listed on foreign boards of trade ("FBOTs"), in addition to U.S. listed futures and option contracts. Commissioners Michael Dunn and Jill Sommers have both expressed concern regarding the imposition of new federal energy position limits without the authority to impose similar position limits on OTC derivatives and FBOT contracts.[9]

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6 SPDCs are defined to include contracts traded on ECMs that are linked to exchange-traded contracts and perform a "significant price discovery function" with respect to such exchange-traded contracts. *See* CEA § 2(h)(7).

7 *See* 74 FR 37988 (July 30, 2009).

8 "Concept Release on Whether to Eliminate the Bona Fide Hedge Exemption for Certain Swap Dealers and Create a New Limited Risk Management Exemption from Speculative Position Limits", 74 FR 12282 (March 24, 2009).

9 *See* Closing Statement of Commissioner Michael V. Dunn, Meeting on Energy Position Limits and Hedge Exemptions (January 14, 2010); Dissenting Statement of Commissioner Jill E. Sommers Regarding the Proposed Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations (January 14, 2010).

II. Covered Contracts.

The Commission's proposed federal position limits would apply only to "referenced energy contracts", initially defined to include four enumerated futures and option contracts—the NYMEX Henry Hub natural gas contract, the NYMEX Light Sweet crude oil contract, the NYMEX New York Harbor No. 2 heating oil contract and the NYMEX NY Harbor gasoline blendstock—and any other futures or option contract that is exclusively or partially based on the underlying commodity of a referenced energy contract and delivered at certain locations specified in the Proposed Regulations. Referenced energy contracts would exclude, however, diversified commodity index contracts (*i.e.*, contracts based on commodity indices with price components that include energy and non-energy commodities) and basis contracts (*i.e.*, contracts that are cash settled based on the difference in price of the same commodity or substantially the same commodity at different delivery points).

III. Proposed Position Limits.

Outside of the spot month, referenced energy contracts are currently subject only to reporting market[10] AMC and single-month position accountability levels.[11] Under the Proposed Regulations, referenced energy contracts would also be subject to hard cap federal position limits both inside and outside of the spot month. Limits would apply both to individual reporting markets as well as across reporting markets.

A. Aggregate Limits.

The Proposed Regulations would establish aggregate AMC and single-month limits[12] that would represent the upper limit of the position an individual trader could hold in any given referenced energy contract across U.S. reporting markets, absent a federal position limit exemption. Similar to the current formula by which exchanges are required to establish speculative position limit levels under CFTC Rule 150.5(c)(2), the aggregate AMC limit would be set at 10% of the open interest of the relevant referenced energy contract aggregated across reporting markets up to 25,000 contracts, with a marginal increase of 2.5% of aggregate open interest thereafter. The aggregate single-month position limit would, in turn, be set at two-thirds of the aggregate AMC position limit.

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[10] Under CFTC Regulation § 15.00, the term "reporting market" is defined to include both designated contract markets and ECMs with respect to SPDCs, thereby covering both NYMEX and ICE.

[11] In contrast to position limits, position accountability levels are not hard limits above which a trader is in immediate violation of a reporting market's rules. However, once a trader exceeds a reporting market's position accountability level, the reporting market has the right to request supporting justification from the trader for the size of its position, and may order the trader to reduce or to not further increase its position.

[12] In determining compliance with the proposed federal position limits, traders would effectively be permitted to compute option position size on a delta-adjusted basis.

According to the Commission, traders would be allowed to net positions in a given referenced energy contract on a single reporting market (*i.e.*, physically delivered and cash settled positions), as well as positions in the same referenced energy contract on different reporting markets, in computing their aggregate AMC and single-month positions.

B. Reporting Market Limits.

The Proposed Regulations would also establish AMC and single-month position limits at the reporting market level. However, in contrast to the proposed aggregate limits discussed above, which would require aggregation across positions in a particular referenced energy contract regardless of settlement method, at the reporting market level, separate limits would be set for physically delivered and cash settled referenced energy contracts. Only referenced energy contracts that are (i) listed on the same reporting market and (ii) delivered in the same manner (*i.e.*, physically delivered or cash settled) would constitute the same "class" of contracts for purposes of compliance with the reporting market AMC and single-month position limits.

The reporting market AMC position limit for a particular class of contracts would generally be the lower of (i) the aggregate AMC position limit for the referenced energy contract and (ii) 30% of such class's average combined futures and delta-adjusted option month-end open interest for the most recent calendar year on that reporting market. In order to allow contracts with low open interest, including newly listed contracts, to attract liquidity, the Commission has proposed an alternative minimum reporting market AMC position limit that would be set at the greater of 5,000 contracts and 1% of the open interest aggregated across all reporting markets. It is not clear, however, that such an alternative minimum limit would address all possible scenarios without creating additional quantitative constraints on positions.

As in the case of the Commission's proposed aggregate single-month position limits discussed above, the reporting market single-month position limit for a given class of contracts would generally be set at two-thirds of the corresponding reporting market AMC position limit. However, in order to prevent a trader's gross positions from causing sudden or unreasonable fluctuations or unwarranted changes in the price of a commodity underlying a referenced energy contract, although when netted out such positions may fall within the applicable reporting market limit, the Proposed Regulations would also prohibit traders from holding in any single month gross positions in contracts of the same class that are greater than twice the reporting market AMC position limit for that class.

C. Spot Month Limits.

The Commission has also proposed to establish federal spot month position limits for referenced energy contracts.[13] According to the Commission, in the case of major energy contracts, the "spot month" generally refers to the last three trading days prior to the expiration of the relevant contract.[14] Consistent with the Commission's current formula for exchange-set spot month position limits under CFTC Rule 150.5(b)(1), for physically delivered referenced energy contracts, the Proposed Regulations would fix the federal spot month position limit at 25% of the estimated spot month deliverable supply. For a referenced energy contract that cash settles based on the price of a physically delivered contract, the default federal spot month position limit would be equal to that applicable to its physically delivered counterpart. However, a trader, if permitted by the relevant reporting market, would be allowed to hold positions in spot month cash settled referenced energy contracts up to five times such limit if the trader "does not hold positions in spot-month physically-delivered referenced energy contracts"[15] and complies with certain reporting requirements.

Similar to the class categorization used by the Commission in the context of the proposed reporting market position limits discussed above, the Commission would categorize referenced energy contracts as being in the same "class" for spot month position limit purposes if such contracts (i) are listed on the same reporting market, (ii) are delivered in the same manner (*i.e.*, physically delivered or cash settled) and (iii) expire on the same trading day. According to the Notice of Proposed Rulemaking, the Commission's intent in defining the same "class" to include only contracts expiring on the same trading day is to prohibit traders from being able to net spot month contracts that expire on different days (*e.g.*, last trading day and penultimate contracts) for purposes of applying the proposed spot month position limits. However, in so doing, the Proposed Regulations as drafted would appear also to establish separate position limits for contracts expiring on different trading

[13] Referenced energy contracts are generally already subject to spot month position limits at the reporting market level.

[14] It is not entirely clear from the Proposed Regulations whether the Commission intends to establish only exchange-specific federal spot month position limits, or aggregate federal spot month limits as well. *See* Proposed Regulations § 151.1 (definition of "contracts of the same class"), § 151.2(a) and § 151.2(f)(1).

[15] Although the Proposed Regulations are not entirely clear, based on the language in the Notice of Proposed Rulemaking, it appears that the Commission intends this language to only limit a trader's ability to hold spot month physically delivered referenced energy contracts that are "linked" to its spot month cash settled positions.

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days in the spot month, as each would be a different "class" of spot month contracts.[16] We presume this result was unintended.

IV. Proposed Exemptions.

The Commission contemplates three types of exemptions from its proposed federal energy position limits: (i) *bona fide* hedge exemptions, (ii) new limited risk management exemptions for swap dealers and (iii) exemptions for delta-adjusted positions.

A. *Bona Fide* Hedging Exemption.

Under the Proposed Regulations, traders using referenced energy contracts to hedge commercial risks would, consistent with current practice, apply to the relevant reporting markets for *bona fide* hedging exemptions from the proposed federal position limits. The Commission would, in turn, audit this process in order to ensure that the reporting markets are appropriately reviewing and acting on such requests.

The proposed *bona fide* hedging exemption would be narrow in scope, limited to the hedging of physical commercial positions and would not extend to the broader category of risk management positions (or positions hedging financial risks as opposed to physical positions) that are currently eligible for position limit exemptions.

Notably, the Proposed Regulations would generally count *bona fide* hedging transactions against a trader's ability to hold speculative positions in referenced energy contracts. Specifically, a trader holding positions in a referenced energy contract greater than or equal to a proposed limit pursuant to a *bona fide* hedge exemption would be prohibited from also holding a speculative position of any size in such contract.[17] In addition, a trader holding non-spot month positions greater than or equal to twice a federal position limit pursuant to a *bona fide* hedge exemption would be prohibited under the Proposed Regulations from also holding risk management positions pursuant to the swap dealer exemption described below. According to the Notice of Proposed Rulemaking, the Commission intends for these "crowding out" provisions to limit traders' ability to acquire speculative positions or swap dealer risk management positions when they already hold "very large" positions pursuant to *bona fide* hedge exemptions. In light of these "crowding out" provisions, it is not clear that the proposed position limits for referenced energy

[16] *See* Proposed Regulation § 151.2(a) ("Spot-month position limits. Except as otherwise authorized in § 151.3, no person may hold or control positions in contracts *of the same class* when such positions, net long or net short, are in excess of" the applicable spot month limit. (Emphasis added)).

[17] A limited exception would apply in the case of traders holding spot month positions pursuant to a *bona fide* hedge exemption; although the language of Proposed Regulation § 151.3(a)(1)(i) is not entirely clear, according to the Notice of Proposed Rulemaking, the Commission intends that such traders should not be prohibited from trading speculatively outside of the spot month in excess of their spot month hedge exemptions, provided that such positions do not exceed the applicable non-spot month limits.

contracts are appropriately characterized as "speculative" limits and, if they are not, whether the Commission has the authority to impose them.[18]

A trader holding positions in a referenced energy contract pursuant to a *bona fide* hedge exemption would, in addition to any requirements of the reporting market granting the exemption, have separate reporting obligations to the Commission. Specifically, the trader would be required to submit a CFTC Form 40 as well as provide the Commission with certain information regarding its cash market activities, including (i) the quantity of stocks owned of the commodity underlying the relevant referenced energy contract and its products and by-products; (ii) its shares in any investment vehicle (*e.g.*, exchange-traded funds, commodity pools and private investment companies) that holds or owns the referenced energy contract or the underlying commodity and its products and by-products; (iii) the quantity of fixed price purchase and sale commitments open in the commodity underlying the referenced energy contract and its products and by-products; and (iv) for anticipatory hedging transactions, historical and anticipated sales or requirements of the commodity underlying the referenced energy contract.

B. Swap Dealer Risk Management Exemption.

The Proposed Regulations would also significantly alter the exemptions available to swap dealers with respect to the hedging of transactions in swap agreements.[19] Currently, futures positions held by swap dealers outside of the spot month to offset risks related to OTC swap transactions entered into with their customers are generally given the same exempt status as positions held by traders hedging commercial risks. In contrast, the Proposed Regulations would treat swap dealers differently than commercial hedgers, imposing a hard limit on the positions in referenced energy contracts that swap dealers may hold for risk management purposes equal to twice the applicable AMC or single non-spot month position limit. Significantly, swap dealers would not be permitted to exceed the

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[18] As noted above, the CEA only authorizes the Commission to establish position limits for the purposes of diminishing, eliminating or preventing "excessive speculation" causing sudden or unreasonable fluctuations in the price of a commodity, or unwarranted changes in the price of a commodity. *See* CEA §4a(a).

[19] The term "swap agreement" would be defined to have the same meaning as in CFTC Regulation § 35.1(b)(1):

> (i) An agreement (including terms and conditions incorporated by reference therein) which is a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency option, any other similar agreement (including any option to enter into any of the foregoing); (ii) Any combination of the foregoing; or (iii) A master agreement for any of the foregoing together with all supplements thereto.

Application of this definition may lead to significant questions as to whether OTC transactions being hedged with futures would qualify as "swap agreements" where they involve contingent delivery features.

proposed limits even in cases where their OTC swap counterparties are engaged in *bona fide* hedging or other hedging or risk management transactions.

Moreover, as noted above, the Commission would impose "crowding out" restrictions on swap dealers similar to those that would be applicable to commercial hedgers. Specifically, a swap dealer holding positions in a referenced energy contract pursuant to a risk management exemption would be prohibited from also holding speculative positions in such contract, to the extent that the swap dealer's combined risk management and speculative positions would equal or exceed the applicable position limit. Such a restriction would not only have potentially significant consequences for swap dealers' proprietary trading activities, but also for other portfolio trading activities engaged in for risk reduction or risk mitigation purposes that do not fall within the narrow scope of the risk management exemption included in the Proposed Regulations.[20]

In addition, the Proposed Regulations would establish a new application process for swap dealers seeking risk management exemptions from the proposed federal energy position limits. A swap dealer would be required to apply directly to the Commission for a risk management exemption and submit to the Commission, and to the applicable reporting market, monthly reports of its swap positions based on the commodity underlying the applicable referenced energy contract that are held in both customer and proprietary accounts, as well as a summary of its dealing and trading activities in swaps based on such commodity. A swap dealer would also be required to make available to the Commission upon request books and records relating to its dealing activities (including transaction data), as well as a list of the counterparties to its customer swap agreements that substantiate its risk management exemption.

C. Delta-Adjusted Position Exemption.

The Commission would also establish an exemption for a trader whose position would exceed a proposed federal energy position limit if the options position included as part of the trader's overall position were to be delta-adjusted by reference to the previous day's delta for the relevant option, but would not exceed such limit when the options position is computed using the appropriate contemporaneous delta. Traders relying on the exemption would be required to file information regarding their positions to justify their delta calculations.[21]

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[20] Only non-spot month risk management transactions "that are held to offset risks associated with swap agreements, which are entered into to accommodate swap customers and are either directly linked to the referenced energy contracts or the fluctuations in the value of the swap agreements are substantially related to the fluctuations in the value of the referenced energy contracts," would qualify for the swap dealer risk management exemption under Proposed Regulation § 151.3(a)(2).

[21] The Commission does not indicate the parameters for appropriate computation of the delta-based adjustment factor to be used for these purposes.

V. Account Aggregation.

Consistent with the aggregation requirements under CFTC Regulations Part 150 applicable to agricultural commodity contracts, under the Proposed Regulations, a trader would be required to aggregate all positions in referenced energy contracts held in accounts in which it has a 10% or greater equity interest or controls trading, as well as positions held with other persons pursuant to an expressed or implied agreement. An exception would apply in the case of positions in a commodity pool in which the trader is a limited partner or shareholder and has an equity interest of less than 25%, unless such trader actually controls trading in the pool.[22]

However, in contrast to the exemptions from aggregation under CFTC regulations (as well as the NYMEX and ICE rules currently applicable to referenced energy contracts), a trader, irrespective of whether it is futures commission merchant or would otherwise qualify as an "eligible entity",[23] would not be permitted under the Proposed Regulations to disaggregate positions in referenced energy contracts held by "independent account controllers".[24] In the Notice of Proposed Rulemaking, the Commission articulates its concern that the independent account controller exemption may be "incompatible" with the "outer bound" federal position limits it proposes for referenced energy contracts and used by traders to circumvent such limits.

VI. Requests for Comment.

In the Notice of Proposed Rulemaking, the Commission seeks comment on the Proposed Regulations and numerous related issues. For example, while the Proposed Regulations would not classify or treat long-only passive investors differently than other

[22] Interestingly, in contrast to its aggregation requirements for agricultural commodity contracts under CFTC Regulation § 150.4, in the case of referenced energy contracts, the Commission would not establish separate requirements for limited partners who are affiliated with the commodity pool operators managing the pools in which they invest. *See* CFTC Regulation § 150.4(c)(2) (requiring a limited partner with a 10% or greater equity interest in a pool managed by an affiliated commodity pool operator to aggregate such pool's positions with its other positions unless certain informational barriers and other requirements are put in place).

[23] The term "eligible entity" includes, among other persons, commodity pool operators, commodity trading advisors, banks and trust companies, insurance companies and separately organized affiliates of such entities. *See* CFTC Regulation § 150.1(d).

[24] Under CFTC Regulation § 150.1, an "independent account controller" is defined as a registered commodity trading advisor, futures commission merchant, introducing broker, associated person or general partner of a pool for which the pool operator is exempt from registration pursuant to CFTC Regulation § 4.13 who: (i) is authorized by an eligible entity to control independently trading by, and on behalf of, but without the day-to-day direction of the eligible entity, (ii) trades independently of the eligible entity and of any other independent account controller trading for the eligible entity, (iii) is supervised by the eligible entity only to the minimal degree necessary to fulfill its fiduciary responsibilities and duty to supervise diligently the trading done on its behalf and (iv) has no knowledge of trading decisions of any other independent account controller.

traders, subjecting such investors to the same speculative limits with respect to their positions in referenced energy contracts, the Commission requests comment on whether and how its proposed federal energy position limits should apply to long-only passive investors, the criteria the Commission should use to identify such investors and their positions and any unintended consequences that are likely to result from imposing limits on passive long-only positions.

It is clear, both from the comments requested in the Notice of Proposed Rulemaking and the statements of certain Commissioners,[25] that the Commission intends for any federal position limits established for referenced energy contracts to serve as a template for contracts based on other physical commodities with finite supply, notably precious metals. In addition, anticipating the possibility that, as discussed above, it may be given authority in pending legislation to establish position limits for OTC derivatives and certain FBOT contracts, the Commission is also soliciting comment on how it should take such pending legislation into account with respect to its proposed federal energy position limits.

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Please feel free to contact any of your regular contacts at the Firm or any of our partners or counsel listed under Derivatives in the "Practices" section of our website (http://www.clearygottlieb.com) if you have any questions.

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[25] *See* "Moving Forward" Statement of Commissioner Bart Chilton Regarding the Notice of Proposed Rulemaking for Speculative Position Limits for Referenced Energy Contracts (January 14, 2010); Dissenting Statement of Commissioner Jill E. Sommers Regarding the Proposed Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations (January 14, 2010).

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