RECONSIDERING CFTC POSITION LIMITS - LOOKING BACK IN ORDER TO LOOK FORWARD TO THE UPCOMING CFTC POSITION LIMIT PROPOSAL

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Investment Management Alert

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As the new Chairman of the Commodity Futures Trading Commission ("CFTC" or the "Commission"), Chairman Tarbert's short-term agenda is expected to include new position limit rules related to physical commodities.[1] Mr. Tarbert testified at his nomination hearing regarding the importance of finalizing the position limit rule noting that:

> [W]e must acknowledge that these are speculative position limits. . . and therefore people that are bona fide hedgers need to be able to use [the hedging] exemption [from the limits]. So in other words, risk management tools that our [agriculture] sector have used all along should be taken into account. Other issues would include, for example, ensuring that the underlying supply, deliverable supply is taken into account. . .[2]

PRACTICAL IMPLICATIONS

- Market participants who are subject to the position limits rules should review compliance programs and anticipate changes by the CFTC to such limits coming in late 2019 or early 2020.
- Position limits compliance remains a focus area for CFTC enforcement with significant fines levied for position limit violations.[3]
- Violation of a position limit under the Commodity Exchange Act ("CEA"), CFTC regulations, and exchange rules is a "strict liability" offense, meaning that regulators are not required to prove that a trader intended to violate the limit in order to establish liability.
- Violations of a position limit may be regarded by the CFTC as a form of disruptive trading or market manipulation.

POSITION LIMITS BACKGROUND

The intent of position limits is to prevent market manipulation and price distortions by speculators who enter large positions beyond their commercial needs, while at the same time permitting bona fide hedging activities.

Over the past decade,[4] the CFTC has proposed rules to define allowable trading practices, introduce position limits for additional commodity interests, and amend aggregation standards under 17 CFR 150.4 ("Regulation

150.4").[5] To date, only the aggregation rules have been finalized by the CFTC, and the CFTC has had to address challenges that have arisen with administrative no-action relief.[6]

The CFTC has had a long, and at times challenging experience attempting to establish and rationalize position limits. As a result, the CFTC now faces the difficult task of remedying the issues arising from the various rules that have been finalized, withdrawn, or proposed, while at the same time considering updated or different exemptions to promote bona fide hedging activities. Based on public statements from CFTC Commissioners, we anticipate that upcoming rules may include a revised definition of "bona fide hedging," a broader list of enumerated bona fide hedging exemptions, and an improved process for exchange-granted, non-enumerated hedge exemptions.[7]

PREVIOUS POSITION LIMIT PROPOSALS

For nearly a decade, the CFTC has proposed, amended, and proposed again position limit rules and aggregation standards for speculative positions in certain physical commodity contracts and their economic equivalents. The current CFTC position limits define thresholds only for a handful of agricultural products that market participants cannot exceed without hedge exemptions that have been enumerated by the Commission or granted by an exchange.[8] The Commission continues its charge to develop workable speculative position limit rules and practical exemptions.[9] The exchanges' position limits cover a much wider array of products.[10]

THE FIRST POST-DODD-FRANK POSITION LIMIT RULES

Congress tasked the CFTC with limiting price manipulation, fraud-based manipulation, disruptive trading practices, and position limits violations in commodities and related financial products after the financial crisis. In the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), Congress directed the CFTC to set limits on swaps that are economically equivalent to certain commodities to prevent excessive speculation.[11] In response, the CFTC established position limits on speculative positions in futures, exchange-traded option contracts, and swaps related to 28 physical commodities (the "2011 Final Rule").[12] The 2011 Final Rule purported to limit positions held by individual traders or entities to prevent volatility caused by large speculative positions on futures and swaps markets.[13] Initially scheduled to take effect in October 2012, the 2011 Final Rule was challenged. The International Swaps and Derivatives Association and the Securities Industry and Financial Markets Association challenged the CFTC's authority to impose position limits, arguing that the CFTC had failed to make required findings that position limits were necessary to limit market volatility.[14] The District Court for the District of Columbia found these arguments persuasive and invalidated the rules in 2012.[15]

THE 2013 PROPOSED SPECULATIVE POSITION LIMIT RULES

Following the judicial defeat, the CFTC proposed revised position limits on speculative positions in 28 physical commodity contracts and their economically equivalent futures, options, and swaps (the "2013 Position Limit Proposal").[16] The 2013 Position Limit Proposal modified aggregation standards to ensure additional exemptions under Regulation 150.4, including the bona fide hedging exemption and updated reporting requirements for entities claiming exemptions.[17] The proposal revised Regulation 150.2 position limits for all-month, spot-month, and non-spot-month speculative positions.[18] The CFTC considered public comments, revised definitions, and incorporated extensive factual analysis of the necessity of speculative position limits to prevent excessive speculation.[19]

THE 2016 SUPPLEMENTAL POSITION LIMIT PROPOSAL AND TEMPORARY NO-ACTION RELIEF

In 2016, the Commission re-proposed speculative position limits for futures, options, and swaps that are economically equivalent to certain physical commodities.[20] The 2016 supplemental proposal ("2016 Position Limit Proposal") included modified definitions, proposed amendments to the bona fide hedging exemption, and additional reporting requirements for position limit exemptions.[21] The CFTC also published final amendments on aggregation of commodity positions for certain speculative position limits under Regulation 150.4 ("Aggregation of Positions").[22]

Since 2016, the CFTC has granted temporary no-action relief from notice filing requirements under Regulation 150.4(c) and aggregation rules under Regulation 150.4(b) that did not align with market realities.[23] Staff Letter No. 17-37 from the Division of Market Oversight ("DMO") of the CFTC granted the current two-year relief period, which limits the scope of the term "trading" under Regulation 150.4(b) to include derivatives trading, but not cash-market trading.[24] The relief period limited the scope of the reference to derivatives trading for certain purposes related to notice filing requirements for aggregation exemptions.[25] The relief, granted in response to requests from market participants subject to the 2016 Position Limit Proposal, provides a streamlined notice filing process for those who qualify for the owned-entity aggregation exemption from Regulation 150.4.[26] The relief was set to expire on August 12, 2019, however, on August 1, 2019, CFTC Staff extended this relief until August 12, 2022.[27]

UPCOMING POSITION LIMIT PROPOSAL

Now, for the fourth time since 2011, the CFTC is expected to propose position limit rules for speculative positions in futures, exchange-traded commodity options, and swaps related to certain physical commodities.[28] It is expected that a key focus of the proposal will be the ability of commercial market participants and end-users to engage in bona fide hedging activity, as well as the promotion of market stability and liquidity through the position limits.

To accomplish these objectives, the upcoming proposal is expected to broaden the definition of "bona fide hedging," expand the list of enumerated bona fide hedging exemptions, and permit exchanges to recognize non-enumerated bona fide hedge or spread exemptions.[29] It is possible that the CFTC will reconsider using accountability levels in lieu of hard limits in non-spot months and will reassess the practicality of imposing position limits for economically equivalent swaps.[30] It is also expected that a new proposal may update the deliverable supply estimates to establish spot-month speculative limits and remove the quantitative test for cross-commodity hedges.

UPDATING THE "BONA FIDE HEDGING" DEFINITION

To encourage efficient hedging activity, CFTC Commissioners have noted in public speeches that a position limit proposal may broaden the current definition of "bona fide hedging" to include legitimate, risk-reducing activities and may eliminate the incidental test and the orderly trading requirement test.[31] The Commission may retain the "economically appropriate test," which is used to determine whether a position qualifies as a bona fide hedge that is economically appropriate to reduce risk.[32] The Commission may also re-examine the interpretation of the word "risk," which refers only to price risk, in response to public comments that the current interpretation is too narrow.[33] It is also expected that the updated proposal might clarify the requirement that an enterprise "take into account all inventory or products that the enterprise owns or controls. . ." and ensure that the test reflects the realities of businesses that participate in regional markets.[34]

EXPANDING THE LIST OF ENUMERATED BONA FIDE HEDGING POSITIONS

To give market participants more flexibility to hedge risks, the upcoming proposal is expected to consider common commercial hedging strategies and adjust the list of enumerated bona fide hedging positions.[35] It is also expected that the proposal may add important market activities, such as anticipated merchandising, to the list.[36] Commissioner Quintenz has observed that the exclusion of these terms from the current enumerated bona fide hedging positions list forces end-users to incur unnecessary costs in exchange for bona fide status.[37]

CFTC OVERSIGHT OF THE NON-ENUMERATED HEDGE EXEMPTION PROCESS

It is also expected that a position limit proposal may include a streamlined process for the CFTC to review and recognize non-enumerated bona fide hedge exemptions granted by exchanges.[38] Under the 2016 Position Limit Proposal, certain exchanges had the authority to grant exemptions for non-enumerated bona fide hedges, anticipatory bona fide hedges, and spread positions. However, the process involved uncertainty because the CFTC could overturn exchange-granted, non-enumerated, hedge exemptions.[39] According to Commissioner Quintenz, an upcoming proposal might incorporate the exchanges' processes for granting non-enumerated hedge exemptions into the CFTC's Rule Enforcement Review process to ensure that exchange-granted exemptions are consistent with the Commission's determinations.[40]

A PERIOD OF TRANSITION FOR THE CFTC

The anticipated speculative position limit proposal will come during a transition period for the Commission and its position limits regulatory regime. Heath Tarbert has transitioned into his role as Chairman, and former Chairman J. Christopher Giancarlo has left the CFTC. In recent months, CFTC leadership has expressed the Commission's intentions to produce workable position limit rules that reflect commercial hedging practices.[41] The timing may be right for progress on position limit rules as all five CFTC Commissioners have committed to move forward with a final position limit rule.[42]

Although the process has been challenging at times, the CFTC's upcoming proposal should benefit from past experience. The Commission is actively soliciting and incorporating market participants' input before promulgating the proposal.[43] Position limits will be a key area to follow as the expected season of fall rulemaking comes into full swing. The global futures and derivatives team at K&L Gates continues to follow these and other upcoming developments at the CFTC, including changes to the swaps trading rules, cross-border guidance, and margin for uncleared swaps.

*Nicole Banton, a summer associate at K&L Gates, was also a contributing author to this article.

Notes:

[1] Dan Berkovitz, Keynote Address of Commissioner Dan M. Berkovitz at the FIA Commodities Symposium, Houston, Texas (June 11, 2019), transcript available at https://www.cftc.gov/PressRoom/SpeechesTestimony/opaberkovitz4.

[2] Nomination Hearing of Heath P. Tarbert, of Maryland, to be Chairman and a Commissioner of the CFTC (Mar. 13, 2019), transcript available at https://www.agriculture.senate.gov/imo/media/doc/03.13.19%20Nomiation%20Hearing%20of%20Heath%20P.%20Tarbert.pdf.

[3] CFTC, NO. 7790-18, CFTC FILES 12 ENFORCEMENT ACTIONS ADDRESSING REGISTRATION, POSITION LIMITS, RECORDKEEPING, SUPERVISION AND REPORTING (2018).

[4] On July 28, 2009, the CFTC convened a hearing on position limits at which Senator Bernard Sanders and then CFTC General Counsel Dan Berkovitz testified. https://www.cftc.gov/PressRoom/Events/oeaevent072809. A video of the hearing is available here: https://www.youtube.com/watch?v=Q9bGBGhAXyc&feature=youtu.be.

[5] Prior CFTC Regulation 150.2 sought to establish speculative position limits for certain commodities that trade on designated contract markets. Position Limits for Futures and Swaps, 76 Fed. Reg. 71625, 71626 (Nov. 28, 2011). However, this prior CFTC Regulation 150.2 was struck down by a U.S. District Court, as discussed below. The position limit rules were then re-proposed in 2013 (the "2013 Position Limit Proposal"). See Position Limits for Derivatives, 78 Fed. Reg. 75680 (Dec. 12, 2013). The 2013 Position Limit Proposal then went through public round tables, several re-opening of comment periods, and certain aspects were re-proposed. *See also* Position Limits for Derivatives: Certain Exemptions and Guidance, 81 Fed. Reg. 38458 (June 13, 2016). *See generally*, Position Limits for Derivatives and Aggregation of Positions, available at https://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/PositionLimitsforDerivatives/index.htm. In 2016, the CFTC finalized rules related to aggregation of positions. See Aggregation of Positions, Final Rule, 81 FR 91454 (Dec. 16, 2016). We discuss this and other position limit history below. Aggregation provisions govern when positions of related traders must be combined to determine compliance with limits.

[6] *See* Aggregation of Positions, Final Rule, 81 FR 91454 (Dec. 16, 2016); CFTC, STAFF LETTER NO. 17-06, (2017); and CFTC, STAFF LETTER NO. 17-37 (2017).

[7] CFTC Commissioner Brian Quintenz, Remarks of Brian Quintenz before the Commodity Market Council State of the Industry 2018 Conference (Jan. 29, 2018), transcript available at https://www.cftc.gov/PressRoom/SpeechesTestimony/opaquintenz5.

[8] Position Limits, 17 C.F.R. § 150.2 (2011).

[9] *Int'l Swaps and Derivatives Assoc. v. CFTC*, 887 F. Supp. 2d 259 (D.D.C. 2012) (challenging the CFTC's authority to impose speculative position limits for derivatives). Berkovitz, supra note 1 (stating that the Commission will finish its speculative position limit rulemaking "in a careful and deliberate manner"). Dawn Stump, CFTC's Stump outlines speculative position limit rule objectives (June 14, 2019), available at https://www.ngfa.org/newsletter/cftcs-stump-outlines-speculative-position-limits-rule-objectives/.

[10] 17 C.F.R. § 150.5.

[11] Quintenz, *supra* note 7 (citing CEA of 1936, P.L. 74-675, 49 Stat. 1491, § 5 (adding section 4a), available at https://fraser.stlouisfed.org/scribd/?title_id=1096&filepath=/files/docs/historical/congressional/commodity-

exchange-act.pdf). The CFTC had authority to set and to enforce position limits on futures and option contracts before 2010, but the Dodd-Frank Act extended the CFTC's authority to establish position limits for speculative physical commodities and their economic equivalents.

[12] Position Limits for Futures and Swaps, 76 Fed. Reg. 71625, 71626 (Nov. 28, 2011).

[13] *Id*. The 2011 final rule carved out several exemptions, including a bona fide hedging exemption, an exemption for spread or arbitrage positions between single months of a futures contract or an option contract, and an exemption for positions held for an entity in an account belonging to an independent account controller that manages positions.

[14] *Int'l Swaps and Derivatives Assoc. v. CFTC*, 887 F. Supp. 2d 259, 266 (D.D.C. 2012).

[15] *Id*. at 269 (holding that the CFTC had misinterpreted Section 6a (a) (1) of the CEA and that the Commission lacked authority to impose the challenged position limits because Section 6a (a) (1) "clearly and unambiguously requires the Commission to make a finding of necessity prior to imposing position limits").

[16] 78 Fed. Reg. 75680 (Dec. 12, 2013).

[17] *Id*.

[18] *Id*. The spot-month position limits applied to the period immediately before delivery obligations for physical delivery contracts or before contracts are liquidated by a clearinghouse. The non-spot-month position limits applied to positions in all contract months combined or in a single contract month.

[19] *Id*.

[20] Position Limits for Derivatives, 81 Fed. Reg. 96704 (Dec. 30, 2016).

[21] *Id*. at 96742 (updating the definition of "bona fide hedging").

[22] Aggregation of Positions, 81 Fed. Reg. 91454 (Dec. 16, 2016).

[23] CFTC, STAFF LETTER NO. 17-06, (2017). CFTC, STAFF LETTER NO. 17-37 (2017).

[24] DMO applied the owned-entity exemption to related entities that were aware of each other's cash marketing trading decisions.

[25] CFTC, STAFF LETTER NO. 17-37 (2017).

[26] Exemption for certain ownership of greater than 10 percent in an owned entity, 17 C.F.R. 150.4 (b) (2) (2016), as amended at 82 Fed. Reg. 28770 (2017). CFTC Regulation 150.4 requires any person who directly or indirectly controls trading or holds 10 percent or more of the equity or ownership interests in another entity to aggregate all Rule 150.2 positions in accounts of the owned entities with the positions held or controlled by the common owner. CFTC Rule 150.4 provided exemptions from aggregation through a notice filing process, but these exceptions are limited. CFTC, STAFF LETTER NO. 17-06, (2017). *Id*.

[27] CFTC, STAFF LETTER NO. 19-19 (2019)

[28] Position Limits, 17 C.F.R. § 150.2 (2011). Berkovitz, *supra* note 1.

[29] Quintenz, *supra* note 7.

[30] *Id*. Accountability levels require a trader to provide information about its position upon request and to consent to halt increasing further its position if so ordered, but a breach thereof is not a rule violation.

[31] Berkovitz, *supra* note 1. Quintenz, supra note 7. See also Definitions, 17 C.F.R. § 1.3 (1976). Position Limits for Derivatives: Certain Exemptions and Guidance, 81 Fed. Reg. 38458, 38462 (June 13, 2016). The incidental test requires that the purpose of a bona fide hedging position "is to offset price risks incidental to commercial cash, spot, or forward operations." The orderly trading requirement mandates that a position "is established and liquidated in an orderly manner in accordance with sound commercial practices."

[32] Position Limits for Derivatives, 78 Fed. Reg. 75680 (Dec. 12, 2013). *See also* Quintenz, *supra* note 7.

[33] Position Limits for Derivatives, 81 Fed. Reg. 96704, 96746–47. Position Limits for Derivatives: Certain Exemptions and Guidance, 81 Fed. Reg. 38458, 38463 (June 13, 2016). *See also* Quintenz, *supra* note 7.

[34] 78 Fed. Reg. 75680 (Dec. 12, 2013). See also Quintenz, *supra* note 7.

[35] Definitions, 17 C.F.R. § 150.1 (1987), amended as 81 Fed. Reg. 91489 (Dec. 16, 2016). *See also* Quintenz, *supra* note 7.

[36] Quintenz, *supra* note 7.

[37] *Id*.

[38] Quintenz, *supra* note 7.

[39] *Id*.

[40] *Id*.

[41] Berkovitz, *supra* note 1.

[42] Quintenz, *supra* note 7. These "regulatory tools" include "special call powers of the agency, market surveillance capabilities, large trader reporting obligations, and exchange-set accountability levels in various contract months." J. Christopher Giancarlo, Remarks of Chairman J. Christopher Giancarlo at 44th Annual International Futures Industry Conference (Mar. 13, 2019), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo67.

[43] Giancarlo, *supra* note 42.

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