FINAL CFTC RULE ON POSITION LIMITS

December 6, 2011

To Our Clients and Friends:

On October 18, the U.S. Commodity Futures Trading Commission (the "CFTC") adopted new Part 151 (the "Final Rule") of its regulations on position limits for certain physical commodities. The Final Rule was published in the Federal Register on November 17, 2011.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") amended section 4a of the Commodity Exchange Act (the "CEA") to require the CFTC to establish position limits for futures and options contracts traded on a designated contract market ("DCM"), and swaps that are economically equivalent to such futures and options contracts. In addition, the CFTC is required to establish aggregate position limits for contracts based on the same underlying commodity that include, in addition to futures and options contracts, (1) contracts listed by DCMs, (2) swaps that are not traded on a registered entity but which are determined to perform or affect a 'significant price discovery function,' and (3) foreign board of trade ("FBOT") contracts that are price-linked to a DCM or swap execution facility ("SEF") contract and made available for trading on the FBOT by direct access from within the United States.

REFERENCED CONTRACTS

The Final Rule applies with respect to "Referenced Contracts." If futures or swaps are not Referenced Contracts, there is no restriction under the Final Rule on the amount of such futures or swaps held by any trader.

A Referenced Contract includes (1) a Core Referenced Futures Contracts and (2) a futures contract, options contract, swap or swaption (other than a basis contract or contract on a commodity index) that is (a) directly or indirectly linked, including being partially or fully settled on, or priced at a fixed differential to, the price of a Core Referenced Futures Contract or (b) directly or indirectly linked, including being partially or fully settled on, or priced at a fixed differential to, the price of the same commodity underlying a Core Referenced Futures Contract for delivery at the same location or locations as specified in such Core Referenced Futures Contract.

Core Referenced Futures Contracts

The Final Rule sets forth 28 Core Referenced Futures Contracts.[1] They are on futures contracts traded on DCMs on certain agricultural, energy and metal commodities. Nine of the Core Referenced Futures Contracts are legacy contracts that have been subject to federal position limits under Part 150 of the CFTC regulation. In addition, options that expire into outright positions in Core Referenced Futures Contracts are also Core Referenced Futures Contracts.

Other Referenced Contracts

In the Release, the CFTC states that the second type of Referenced Contract includes a "look-alike" contract (*i.e.*, a contract that settles off of a Core Referenced Futures Contract and a contract that is based on the same commodity for the same delivery location as a Core Referenced Futures Contact), (3) a contract with a reference price based only on the combination of at least one Referenced Contract price and one or more prices in the same or substantially the same commodity as that underlying the relevant Core Referenced Futures Contract, and (4) an intercommodity spread with two components, one or both of which are Referenced Contracts. According to the CFTC's release accompanying the Final Rule (the "Release"), these criteria capture contracts with prices that are or should be closely correlated to the prices of the Core Referenced Futures Contract.

The Final Rule does not include in the category of Referenced Contract contracts based on "substantially the same supply and demand fundamentals," which, according to the CFTC, would require individualized evaluation of certain trading data that are not readily available currently to the CFTC.

In the Release, the CFTC stated that the swap is a Referenced Contract, if the sole floating reference price of a swap is based on the prices generated directly or indirectly from the price of a single Core Referenced Futures Contract or if a swap is priced based on a fixed differential to a Core Referenced Contract. On the other hand, if a swap is based on the difference in price of a

---

[1] *Core Referenced Futures Contracts are the following futures contracts and options thereon: (1) Core Referenced Futures Contracts in legacy agricultural commodities: CBOT Corn, CBOT Oats, CBOT Soybeans, CBOT Soybean Meal, CBOT Soybean Oil, CBOT Wheat, ICE Futures U.S. Cotton No. 2, KCBT Hard Winter Wheat, and MGEX Hard Red Spring Wheat; (2) Core Referenced Futures Contracts in non-legacy agricultural commodities: CME Class III Milk, CME Feeder Cattle, CME Lean Hog, CME Live Cattle, 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, and ICE Futures U.S. Sugar No. 16; (3) Core Referenced Futures Contracts in metal commodities: COMEX Copper, COMEX Gold, COMEX Silver, NYMEX Palladium, and NYMEX Platinum; (4) Core Referenced Futures Contracts in energy commodities: NYMEX Henry Hub Natural Gas, NYMEX Light Sweet Crude Oil, NYMEX New York Harbor Gasoline Blendstock, and NYMEX New York Harbor Heating Oil.*

commodity (or substantially the same commodity) at different delivery locations, then the swap is a 'basis contract' and is not subject to the limits under the Final Rule. Also, if a swap is based on prices of multiple different commodities comprising an index, the swap is a 'commodity index contract' and is not subject to limits under the Final Rule. However, if swap is based on the difference between prices of two different commodities with one linked to a Core Referenced Futures Contract (and the other either not linked to the price of the same Core Referenced Futures Contract or linked to the price of a different Core Referenced Futures Contract), the swap is an 'intercommodity spread contract' rather than a commodity index contract and is a Referenced Contract subject to the limits under the Final Rule.[2]

In the Release, the CFTC stated that it will consider amending the scope of economically equivalent contracts (and the relevant identifying criteria) as it gains experience.

---

[2] *For example, Referenced Contracts include: (1) a swap with the commodity reference price of the January 2012 NYMEX Light Sweet Crude futures contract ("NYMEX CL") settlement price plus $3 per barrel, (2) a swap with a floating price based on the average of the settlement price of the January 2012 NYMEX CL and the settlement price of the January 2012 ICE Brent crude oil futures, (3) a swap with the commodity reference price of the average of daily spot prices for natural gas deliverable at Henry Hub during January 2012 as reported by Platts, and (4) a swap based on the difference between two prices of two different commodities with one linked to the January 2012 NYMEX CL and the other either not linked to such NYMEX CL (such as the January 2012 ICE Brent crude oil futures) or linked to the February 2012 NYMEX CL.*

Referenced Contracts do not include (1) basis swaps (swaps based on the difference in the price of a commodity (or substantially the same commodity) at different delivery locations (such as a SoCal City-gate basis swap, the floating price of which is based on the Platts IFERC SoCal City-gate index minus the NYMEX Henry Hub Natural Gas futures settlement price), (2) commodity index swaps (swaps based on the prices of multiple different commodities comprising an index), or (3) swaps with the commodity reference price of unfixed differential to a Core Referenced Futures Contract (such as swaps based on the Argus sour crude oil index).

LEVELS OF LIMITS[3]

Spot-Month Limits

Under the Final Rule, the spot-month[4] limits for physical-delivery Core Referenced Futures Contracts will be initially set at existing DCM levels, and cash-settled Referenced Contracts will also be subject to limits set at the same level. The initial compliance period will commence on the 60th day after the CFTC further defines the term 'swap.' After such date, the existing Part 150 will be revoked and the Final Rule (the new Part 151) will apply. Until such date, traders will continue to be subject to limits imposed by DCMs with respect to non-legacy Referenced Contracts. During the first phase, nine legacy Referenced Contracts (all agricultural commodities) will be subject to position limits imposed by the Final Rule.

During the second phase of implementation, the spot-month limits will be based on 25% of estimated deliverable supply. The second phase will commence on January 1 of the second calendar year after the CFTC further defines the term 'swap.' During the second phase, the spot-month position limits for agricultural commodities will be set annually, while the spot-month position limits for metal and energy commodities will be set biannually.

The term 'deliverable supply' generally means the "quantity of the commodity meeting a derivative contract's delivery specifications that can reasonably be expected to be readily available to short traders and saleable by long traders at its market value in normal cash marketing channels at the derivative contract's delivery points during the specified delivery period, barring abnormal movement in interstate commerce." The dates on which the deliverable supply is determined for each commodity may be staggered throughout the year. The CFTC may use an estimate of the deliverable supply for each commodity submitted by the relevant DCM or may instead use its own estimate in setting spot-month position limits.[5]

---

3 *The Release made it clear that spot-month and non-spot-month limits need to be complied with during a trading day.*

4 *The Final Rule provides for the spot month for each Core Referenced Futures Contract. For example, the spot month for a COMEX Gold contract is the period commencing at the close of business on the business day prior to the first notice day for the delivery month for such futures and ending at the end of the delivery period for such futures contract, while the spot month for the NYMEX New York Harbor No. 2 Healing Oil futures contract is the period commencing at the close of business of the third business day prior to the last day of trading in such futures contract and ending at the end of the delivery period for such futures contract.*

5 *In the Release, the CFTC stated that the use of deliverable supply to set spot-month limits is wholly consistent with its historical approach to setting spot-month limits and overseeing DCMs' compliance with DCM Core Principle 3. The Final Rule clarifies that for purposes of estimating*

As part of the Final Rule, the CFTC adopted, on an interim final rule basis, the spot-month position limits for cash-settled contracts using the same methodology as applied to the physical-delivery contracts, with the exception of natural gas Referenced Contracts (the Core Referenced Futures Contact of which is the NYMEX Henry Hub Natural Gas futures). Cash-settled contracts on natural gas will have a class limit and aggregate limit of five times the level of the limit for the physical-delivery Core Referenced Futures Contract.[6] The spot-month limits for cash-settled contracts are adopted on an interim final rule basis, so that the CFTC may in the future switch from the one-to-one ratio between physical-delivery and cash-settled contracts to a different ratio based on its experience with the one-to-one ratio and additional reporting of swaps.

With respect to cash-settled Core Referenced Futures Contracts (*i.e.*, Class III Milk, Feeder Cattle, and Lean Hog) and related cash-settled Referenced Contracts, limits will be set at 25% of deliverable supply.

The Final Rule retains class limits in the spot month for physical-delivery and cash-settled contracts. Under the class limit restriction, a trader may hold positions up to the spot-month limit in the physical-delivery contracts as well as positions up to the applicable spot-month limit in cash-settled contracts (*i.e.*, cash-settled futures and swaps), but a trader in the spot month may not net across physical-delivery and cash-settled contracts. As to natural gas contracts, the Final Rule also imposes an aggregate directional limit set at the level of five times of the spot-month limit for the physical-delivery natural gas Core Referenced Futures Contract.[7]

---

deliverable supply, DCMs may use any guidance issued by the CFTC set forth in the Acceptable Practices for Core Principle 3. Further, the CFTC stated in the Release that the use of 25% of delivery supply in setting spot-month limits is consistent with Core Principle 5.

6 *In the Release, the CFTC stated that the parity between in physical-delivery and cash-settled Referenced Contracts (other than natural gas) is necessary in order to eliminate an incentive to manipulate and undermine price discovery in the underlying physical-delivery futures contract, but that the CFTC has a reasonable basis to believe that the cash-settled market in natural gas is sufficiently different from the cash-settled markets in other physical commodities to warrant a different methodology.*

7 *If the spot-month limit for physical-delivery natural gas contracts is 1,000 contracts, a trader may hold no more than 5,000 of both physical-delivery and cash-settled contracts on the same side of the market (i.e., the maximum of 1,500 physical-delivery contracts and 4,000 cash-settled contracts). Also, if a trader holds 1,000 physical-delivery contracts on the long side of the market, it may not hold more than 5,000 cash-settled contracts on the short-side of the market due to the class limits.*

Non-Spot-Month and All-Months-Combined Limits

In the second phase, non-spot-month and all-months-combined position limits will be imposed with respect to non-legacy Referenced Contracts.

Initially the CFTC will set non-spot-month and all-months limits at the same level with respect to non-legacy Referenced Contracts. These initial limits will be set at 10% of the open interest (combined open futures and swaps interest) of a Referenced Contract up to the first 25,000 contracts of aggregate open interest plus a marginal increase of 2.5% thereafter. These limits will be published within one month after the CFTC has obtained or estimated 12 months of data on the open interest levels as determined or estimated by the CFTC. The Release stated that this is "the same formula that has been historically used to set position limits" on DCMs.

Subsequent limits for non-legacy Referenced Contracts will be based on the higher of the most recent 12-month average of all-month-combined aggregate open interest or the 24-month average of all-months-combined aggregate open interest, and revised in accordance with the staggered schedule provided in the Final Rule.[8] In the Release, the CFTC noted that the Dodd-Frank Act directed the CFTC to study the effects of position limits and that, based on such study, the CFTC may amend by rulemaking the 10-2.5 formula.

In the case of legacy Referenced Contracts, the Final Rule takes a different approach. Initial non-spot-month and all-months limits for legacy Referenced Contracts are provided in the Final Rule and subsequent limits will be reset by future rulemaking. Again, as in the case of spot-month limits, these initial limits will become effective on January 17, 2012, but the compliance period will commence 60 days after the CFTC further defines the term 'swap.' Until that time, position limits under Part 150 will continue to apply. When the compliance period begins, Part 150 will be revoked, and the position limits under Part 151, together with the other relevant rules including those on account aggregation and bona fide hedging exemption, will apply.

The Final Rule does not impose class limits with respect to non-spot-month and all-months limits. Therefore, a trader is permitted to net all positions in a Referenced Contract (whether physical-delivery contracts or cash-settled contracts) and the net resulting amount will be applied towards the determination of the trader's compliance with non-spot-month and all-months limits.

---

[8] *According to the CFTC, the 'higher of the two' method will permit the CFTC to set limits at a higher level in the event of a decline in open interest due, for example, to a recession, so that the non-spot-month limits will provide sufficient market liquidity for hedgers.*

BONA FIDE HEDGING AND OTHER EXEMPTIONS

Bona Fide Hedging Exemption

The new section 4a(c)(2) of the CEA provides for bona fide hedging exemptions from compliance with federal position limits. The definition of bona fide hedging exemption under section 4a(c)(2) generally follows that under the CFTC Rule section 1.3(z)(1) with two differences. First, the section 4a(c)(2) definition recognizes a position in a futures contract established to reduce the risk of a swap position as a bona fide hedge, provided that either (1) the counterparty to such swap would have qualified for a bona fide hedge exemption (*i.e.*, the pass-through of the bona fides of one swap counterparty to another) or (2) the swap itself meets the requirements of a bona fide hedging transaction. Second, a bona fide hedging transaction or position must represent a substitute for a physical market transaction.

Requirements for Bona Fide Hedging Transactions

To qualify as a bona fide hedging transaction under the Final Rule, a transaction or position must (1) represent a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel, (2) be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, and (3) either (a) qualify as one of the eight enumerated bona fide hedging transactions under the Final Rule and arise from the potential change in the value of (x) assets a person owns, produces, manufactures, processes or merchandises or anticipates owning, producing, manufacturing, processing or merchandising, (y) liabilities a person owes or anticipates incurring or (z) services a person provides, purchases or anticipates providing or purchasing, or (b) qualify as a "pass-through swap."

Enumerated Hedging Transactions

Enumerated bona fide hedging transactions and positions for the purposes of this paragraph mean any of the following specific transactions and positions:

- Sales of Referenced Contracts that do not exceed in quantity:
  - ownership or fixed-price purchase of the contract's underlying cash commodity by the same person; and
  - unsold anticipated production of the same commodity, which may not exceed one year of production for an agricultural commodity, by the same person *provided that* no such position is maintained in any physical-delivery Referenced Contract during the last five days of trading of the Core Referenced Futures Contract in an agricultural or metal commodity or during the spot month for other physical-delivery contracts.

- Purchase of Referenced Contracts that do not exceed in quantity:
  - the fixed-price sale of the contract's underlying cash commodity by the same person;
  - the quantity equivalent of fixed-price sales of the cash products and by-products of such commodity by the same person; and
  - unfilled anticipated requirements of the same cash commodity, which may not exceed one year for agricultural Referenced Contracts, for processing, manufacturing, or use by the same person, provided that no such position is maintained in any physical-delivery Referenced Contract during the last five days of trading of the Core Referenced Futures Contract in an agricultural or metal commodity or during the spot month for other physical-delivery contracts.
- Offsetting sales and purchases in Referenced Contracts that do not exceed in quantity that amount of the same cash commodity that has been bought and sold by the same person at unfixed prices basis different delivery months, provided that no such position is maintained in any physical-delivery Referenced Contract during the last five days of trading of the Core Referenced Futures Contract in an agricultural or metal commodity or during the spot month for other physical-delivery contracts.
- Purchases or sales by an agent who does not own or has not contracted to sell or purchase the offsetting cash commodity at a fixed price, provided that the agent is responsible for the merchandising of the cash positions that is being offset in Referenced Contracts and the agent has a contractual arrangement with the person who owns the commodity or holds the cash market commitment being offset.
- **Anticipated merchandising hedges** Offsetting sales and purchases in Referenced Contracts that do not exceed in quantity the amount of the same cash commodity that is anticipated to be merchandised, provided that:
  - the quantity of offsetting sales and purchases is not larger than the current or anticipated unfilled storage capacity owned or leased by the same person during the period of anticipated merchandising activity, which may not exceed one year;
  - the offsetting sales and purchases in Referenced Contracts are in different contract months, which settle in not more than one year; and

o no such position is maintained in any physical-delivery Referenced Contract during the last five days of trading of the Core Referenced Futures Contract in an agricultural or metal commodity or during the spot month for other physical-delivery contracts.

- **Anticipated royalty hedges** Sales or purchases in Referenced Contracts offset by the anticipated change in value of royalty rights that are owned by the same person provided that:

  o the royalty rights arise out of the production, manufacturing, processing, use, or transportation of the commodity underlying of the Referenced Contract, which may not exceed one year for agricultural Referenced Contracts; and

  o no such position is maintained in any physical-delivery Referenced Contract during the last five days of trading of the Core Referenced Futures Contract in an agricultural or metal commodity or during the spot month for other physical-delivery contracts.

- **Anticipated service hedges** Sales or purchases in Referenced Contracts offset by the anticipated change in value of receipts or payments due or expected to be due under an executed contract for services held by the same person provided that:

  o the contract for services arises out of the production, manufacturing, processing, use, or transportation of the commodity underlying the Referenced Contract, which may not exceed one year for agricultural Referenced Contracts;

  o the fluctuations in the value of the position in Referenced Contracts are substantially related to the fluctuations in value of receipts or payments due or expected to be due under a contract for services; and

  o no such position is maintained in any physical-delivery Referenced Contract during the last five days of trading of the Core Referenced Futures Contract in an agricultural or metal commodity or during the spot month for other physical-delivery contracts.

- **Cross-commodity hedges** Sales or purchases in Referenced Contracts described above may also be offset other than by the same quantity of the same cash commodity, provided that:

- the fluctuations in value of the position in Referenced Contracts are substantially related to the fluctuations in value of the actual or anticipated cash position; and
- no such position is maintained in any physical-delivery Referenced Contract during the last five days of trading of the Core Referenced Futures Contract in an agricultural or metal commodity or during the spot month for other physical-delivery contracts.

A hedging transaction or position must be established and liquidated in an orderly manner in accordance with sound commercial practices. As part of the orderly liquidation requirement, many of the enumerated hedging transactions require a trader not to maintain physical-delivery Referenced Contracts during the last five days of trading or the spot month for the related Core Referenced Futures Contracts. This limitation is imposed because of a situation, such as where a trader that does not own assets but expects to acquire assets is permitted to claim a bona fide hedging exemption with respect to such assets, but the trader does not acquire such assets contrary to expectation. In that situation, the trader may not be able to liquidate the physical-delivery Referenced Contracts used as a bona fide hedge during the last five trading days or during the spot-month in an orderly manner. This limitation may impose an unintended burden on a hedger that needs to liquidate the Referenced Contracts held as a hedge on each trading day during the last month of trading on a ratable basis in order to match its cash market transactions. This restriction does not apply with respect to cash-settled contracts.[9]

In the Release, the CFTC stated that it had never recognized anticipated ownership and merchandising as bona fide hedging transactions because the CFTC historically took the view that anticipatory ownership and merchandising generally fail to meet the second 'appropriateness' prong of the test (in other words, a commercial enterprise that only anticipates purchase or sell inventory has no current risk to hedge against.) The CFTC noted that in a very narrow circumstance (such as when a market participant owns or leases an asset in the form of storage capacity), the market participant may establish hedging positions to reduce the risk

[9] *This restriction on a hedging transaction using a physical-delivery Referenced Contract also applies to all cross-commodity hedges, as, for example, the hedger does not own the commodity which is the underlying commodity of such Referenced Contract. In the Release, the CFTC stated that while it recognized that the restriction on holding cross-commodity hedges in the last five days of trading or in the spot-month may increase tracking risk, if the hedger were forced out of the physical-delivery contract into a lesser correlated contract or into a deferred contract month, it emphasized that such cross-commodity hedges are not appropriately recognized as bona fide in physical-delivery contracts in the same last five trading days or spot-month, since the hedger does not hold the underlying commodity for delivery or have a need to take delivery. However, the CFTC agreed to remove such restriction on cash-settled Referenced Contracts used in bona fide hedging transactions.*

associated with returns anticipated from owning or leasing such capacity, and, accordingly, the Final Rule provides a considerably narrower anticipatory hedging definition than the industry has long operated. The qualified anticipatory hedging transaction has a one-year limitation in certain cases, in that positions in Referenced Contracts established as anticipatory hedging transactions must be liquidated within one year in certain cases. This limitation applies to all Referenced Contracts for anticipatory merchandising hedging, while it applies to only Referenced Contracts in agricultural commodities for other anticipatory hedging.

With respect to the cash market risk, the Final Rule permits a market participant to hedge on a one-to-one transactional basis or to combine the risk associated with all or some of the cash market transactions and establish a bona fide hedging position on a portfolio basis, provided that the hedge is economically appropriate to the reduction of risk in the conduct and management of a commercial enterprise.

Given the limited number of the enumerated bona fide hedging transactions, the Final Rule permits a person that is engaging in risk-reducing practices commonly used in the market that the market participant believes may not be specifically enumerated as one of the eight enumerated bona fide hedging transactions to apply to the CFTC for relief under the CFTC Rule 140.99 or the section 4a(a)(7) of the CEA concerning the applicability of a bona fide hedging transaction exemption.

The CFTC noted in the Release that it chose not to provide bona fide hedge status to each qualifying transaction or position rather than an entity, consistent with the statutory language.

In the Release, the CFTC stated that the Final Rule does not provide for spread exemptions, because the non-spot-month limit and the all-months-combined limit are set at the same level. Similarly, the CFTC noted in the Release that under the existing DCM rules, a trader is permitted to obtain an arbitrage exemption to the extent that the trader has offsetting positions in different trading revenues, but no arbitrage exemption is necessary because the CFTC did not adopt class limits for non-spot-month limits. Because of the class limits, however, a trader may not be able to engage in spread or arbitrage trades in Referenced Contracts in the spot month. In addition, the Final Rule does not provide for netting of inter-commodity spreads unless the positions fall within the same category of Referenced Contracts, but the CFTC stated in the Release that a trader offsetting multiple risks in the physical market may still qualify for a bona fide hedging exemption. Finally, the CFTC chose not to provide for a risk management exemption, as it believed that the elimination of the class limits outside of the spot month permits traders, including swap dealers, to net Referenced Contracts (whether futures or economically equivalent swaps).

The Final Rule clarifies that a transaction may qualify as a bona fide hedging transaction or position regardless of whether or not the trader's position would otherwise exceed the applicable position limit. Therefore, the compliance with position limits by a trader will be measured against only the positions that do not qualify for bona fide hedging treatment. In other words, the positions qualifying for bona fide hedging treatment will not 'crowd out' non-qualifying positions.

If more than one person is required to aggregate accounts or positions under the Final Rule, such persons will be treated as a single person for the purpose of determining whether such persons are eligible for a bona fide hedging exemption to the extent such accounts or positions are attributed to such persons. This aggregation treatment will apply whether or not those persons that are required to aggregate accounts or positions are affiliated or related. Therefore, if two unrelated persons enter into a sales contract on a commodity underlying a Core Referenced Futures Contract and the buyer acquires a position in a Referenced Contract that reduces the risk of the seller from such sales contract in accordance with an agreement or arrangement between the buyer and the seller, such position in a Referenced Contract will qualify as a bona fide hedging transaction on an aggregated basis.

Pass Through Swaps

The Final Rule permits a person to qualify for a bona fide hedging exemption with respect to a "pass-through swap." A pass-through swap will qualify as a bona fide hedging transaction with respect to the purchase or sale of Referenced Contracts in connection with such pass-through swap only if it is executed with a counterparty eligible to claim one of the eight enumerated hedge exemptions (a "bona-fide-counterparty"). A "non-bona fide counterparty" (*i.e.*, the party that is not a bona fide hedger), that will usually be a dealer, may classify a pass-through swap as a bona fide hedging transaction if and only if such non-bona-fide counterparty enters risk reducing positions, whether a futures or swap contracts, with respect to the risk attendant to the pass-through swap. For example, if a person enters a pass-through swap opposite a bona fide hedger, that resulted in a directional exposure of 100 long positions in a Referenced Contract, that person may treat those 100 long positions as a bona fide hedging transaction only if (and to the extent) that person also enters into 100 short positions to reduce the risk arising from the pass-through swap.[10] As a corollary matter, positions in Referenced Contracts that reduce the risk of pass-through swaps qualify as a bona fide hedging transaction, provided that no such position is maintained in any physical-delivery Referenced Contracts during the last five trading

[10] *As the portfolio based hedging seems to be permitted only with respect to cash market risk, a non-bona fide counterparty may not be able to hedge pass-through swaps on a portfolio basis.*

days for agricultural or metal commodity or during the spot month for energy commodity unless such pass-through swap position continues to offset the cash market commodity price risk of the bona fide hedging counterparty.

In the Release, the CFTC noted that regardless of the bona fide status of a pass-through swap outside of the spot month, the risk-reducing positions in a Referenced Contract will net with the positions from the pass-through swap. Similarly, within the spot-month, the cash-settled Referenced Contracts that reduce the risk from a pass-through swap will net with the pass-through swap for purposes of the spot-month position limits. In addition, while the spot-month limits are subject to the class limits, the physical-delivery Referenced Contracts that reduce the risk from a pass-through swap will net with the pass-through swap, but, as in the case with all bona fide hedging transactions, the non-bona fide counterparty must exit the physical delivery contracts in an orderly manner as it lifts the hedge of the pass-through swap."[11]

The Final Rule does not allow the pass-through swap exemption to extend through a series of swap transactions. In other words, the pass-through swap exemption will be available only with respect to a swap that is executed opposite a counterparty eligible to claim an enumerated hedging exemption.

In order to claim a pass-through swap exemption, a non-bona-fide counterparty must obtain a representation from its counterparty at inception (*i.e.*, execution) of the swap transaction that, in its good-faith belief, the swap will qualify as an enumerated hedge. This representation which may be made in a trade confirmation must be kept for at least two years following the expiration of the swap and must be provided to the CFTC upon request.

The Final Rule also clarifies that a transaction may qualify as a bona fide hedging transaction regardless of whether the hedger's position exceeds the position limit, and the bona fide hedging exemption will pass through to the counterparty regardless of whether the bona fide hedger exceeds the position limits.

Filing Requirements for the Bona Fide Hedging Exemption

With respect to bona fide hedging transactions (other than anticipatory hedging and pass-through swap), a trader must notice file a Form 404 when its position exceeds limits not later

---

[11] *In other words, if a person enters into a pass-through swap opposite a bona fide hedge, either within or outside of the spot-month, that resulted in a directional exposure of 100 long positions in a Referenced Contract, that person may treat such 100 long positions as a bona fide hedging transaction only if that person also entered into 100 short positions to reduce the risk of the pass-through swap.*

than 9 a.m. on the third business day after the position limit was exceeded and, thereafter, not later than 9 a.m. on the third business day following each calendar month during which the trader exceeds the position limit, in each case up to and through the day the trader's position first falls below the limit. Form 404 must contain certain prescribed information, including the type of enumerated hedging transaction, the corresponding Core Referenced Futures Contract, the cash market commodity being hedged and its quantity, and the total number of long and short Referenced Contracts (measured on a futures equivalent basis) used in a hedging transaction. Form 404 will become effective on the date of submission.

In order to claim an exemption based on an anticipatory hedging transaction, a trader must notice file a Form 404A at least 10 business days in advance of the date transactions or positions in a Referenced Contract will be established in an amount that will exceed the relevant position limit. Form 404A must contain certain prescribed information, which is similar to the information required for Form 404 but is modified in light of the anticipatory nature of this hedging exemption (for example, the maximum number of long and short Referenced Contracts to be used as hedge). Notice will become effective after such 10-day period, unless otherwise notified by the CFTC. In addition, the trader that has filed an initial Form 404A must make a supplemental updating filing in the event that the amount of Referenced Contracts to be used in an anticipatory hedging transaction will exceed the initial amount at least 10 days in advance of the date the trader intends to exceed such initial amount.

A trader that exceeds position limits in reliance on a bona hedging transaction exemption for a pass-through swap must notice file Form 404S within the same period of time as is applicable to Form 404. Form 404S must contain certain prescribed information.

The CFTC may require a trader filing Form 404 or 404A to submit such other information, before or after the effective date of notice, as is necessary to enable the CFTC to determine if the transaction under the notice filing is a bona fide hedging transaction.

Transfer of Positions in Financial Distress

The Final Rule includes an exemption from position limits for circumstances of financial distress. The Release noted that several market participants observed that, during periods of financial stress, it may be beneficial for a financially sound entity to assume the positions and corresponding market exposure of a less stable market participant. In response, the Final Rule provides for an additional exemption for market participants, under which a financially sound entity could assume the positions of a less stable market participant for a time certain, upon specific request to the CFTC. The exemption for financial distress does not establish or otherwise represent a form of hedging exemption as this exemption is derived from the CFTC's authority to grant "special exemptions" under section 4a(a)(7) of the CEA.

AGGREGATION OF ACCOUNTS AND POSITIONS

Under the Final Rule, positions in Referenced Contracts in different accounts will be aggregated for purposes of position limits, if the control or ownership requirements are satisfied with respect to such accounts, unless one of the specified exemptions is applicable.

Aggregation—Control and Ownership

Control

If a trader controls the trading of Referenced Contracts maintained in multiple accounts, the trader will aggregate all positions in such accounts. Control is not defined under the Final Rule. Based on a number of CFTC releases including the 1979 Statement of Aggregation Policy, control will exist if a trader has the authority to make a trading decision on the acquisition or liquidation of a specific position or if a trader has the authority to direct all or a portion of trading for an account even though others make specific trading decisions.

Positions held by two or more persons acting pursuant to an expressed or implied agreement or understanding will be aggregated as if the positions were held by, or the trading of the position were done by, a single individual. However, if one of such persons independently trades positions in another account without being subject to such agreement or understanding, the other persons should not aggregate such positions with other positions held by such other persons.

Ownership

- 10% Test: In general, any person that owns directly or indirectly (including by way of power of attorney) a 10% or greater ownership or equity interest in an account must aggregate all such accounts, even if such person does not control the trading of Referenced Contracts in any such account. Therefore, a company must aggregate all positions in Referenced Contracts held by all of the entities in which the company owns a 10% or greater equity interest. This basic test is subject to a number of exceptions. The Final Rule did not adopt a proposed exemption with respect to owned non-financial entities, which exemption would have not required aggregation if a 10% or greater owner could demonstrate that the trading of a 10% owned entity were independently controlled and managed.

- Passive Ownership: The aggregation requirement based on a 10% ownership does not apply where a person owns 10% or more ownership or equity interest in a commodity pool as a limited partner, shareholder or other similar type of pool participant ("Pool

Participant"), other than the following three situations. This general Pool Participant exception makes sense in that such Pool Participant rarely, if ever, have access to trading information, let alone the control of trading of the pool.

- 25% Test: A limited partner, shareholder or other similar type of pool participant ("Pool Participant") that owns 25% or more ownership or equity interest in a commodity pool must aggregate positions held by such commodity pool with positions held by such Pool Participant, if the operator of such commodity pool is exempt from registration under CFTC Rule 4.13.

- Ownership in a Pool and the Pool Operator: A person that is a 10% or more Pool Participant and that is also a principal or affiliate of the pool must aggregate positions held by the pool with all other positions owned or controlled by such person, unless (x) the pool operator has and enforces written procedures to preclude the person from having knowledge of, gaining access to or receiving data about the trading or positions of the pool, (y) the person does not have direct, day-to-day supervisory authority or control over the pool's trading decisions and (z) the pool operator has complied with the notice filing requirements.

- Commodity Pool Operator that is Pool Participant: A commodity pool operator that has 10% or more ownership or equity interest as a Pool Participant in another pool must aggregate positions held by such pool with all other positions owned or controlled by such commodity pool operator.

Aggregation Based on Identical Trading

Even if the ownership requirements are not met, a person that holds or controls the trading of positions, by way of power of attorney or otherwise, in more than one account or that holds or controls trading of accounts or positions in multiple pools, in either case, with identical trading strategies must aggregate all such accounts or positions. This aggregation rule is redundant with respect to the control portion, but the ownership of multiple accounts or in multiple pools with identical trading strategies is an exception to the 10% ownership requirement. The CFTC noted in the Release that this is a rule to prevent avoidance of aggregation by spreading out ownership of positions in multiple accounts which pursue identical trading strategies.

Aggregation Based on the Control of Trading by a Futures Commission Merchant

All positions held by a futures commission merchant ("FCM") or its affiliates in a discretionary account, or in an account which is part of or participates in or receives trading advice from a customer trading program of an FCM or any officer, partner or employee of the FCM or its affiliates must be aggregated, unless (a) a trader other than the FCM or its affiliate directs trading in any such account, (b) the FCM or its affiliate maintains only such minimum control over the trading in any such account as is necessary to fulfill its duty to supervise and (c) each trading decision of the discretionary trading account or the customer trading program is determined independently of all trading decisions in other accounts which the FCM or its affiliates hold, have a financial interest of 10% or more in, or control.

Exceptions

Independent Account Controller

Reversing its proposal to eliminate it, the CFTC retained the independent account controller ("IAC") exemption in the Final Rule. While the CFTC noted in the Release that the IAC exemption in the Final Rule is essentially the same as the one under Part 150, the exemption under the Final Rule appears different from the exemption DCMs have granted under Part 150.

The IAC exemption permits the non-aggregation of the positions or accounts of an 'eligible entity' that are carried by an IAC, except for the spot month provided in physical-delivery Referenced Contracts, if the eligible entity meets the firewall requirements under the Final Rule. The Final Rule makes it clear that all positions controlled or managed by an IAC must not exceed the relevant position limits.

An eligible entity for purposes of the IAC exemption means (i) a commodity pool operator, (ii) the operator of an entity which is excluded, or which itself has qualified for exclusion from the definition of a 'commodity pool operator' under CFTC Rule 4.5, (iii) a limited partner or shareholder of a commodity pool the operator of which is exempt from registration under CFTC Rule 4.13, (iv) a commodity trading advisor, (v) a bank or trust company, or (vi) any affiliate of any entity described above, but only if any such entity satisfies the operational separation requirements. Such requirements are: (x) such entity authorizes an IAC independently control all trading decisions with respect to such entity's client positions and accounts that the IAC hold directly or indirectly, or on behalf of the entity but without the entity's day-to-day direction, and (y) such entity maintains only such minimum control over the IAC as is consistent with its fiduciary responsibilities and necessary to fulfill its duty to supervise (or, in the case of a limited partner or shareholder of an exempt pool under Rule 4.13, only such limited control as is consistent with such status).

An IAC is a person that is authorized by an eligible entity independently to control the trading decisions on behalf of the eligible entity but without the day-to-day direction of the eligible entity and is registered as an FCM, an introducing broker or a commodity trading advisor, or an associated person of such registrant, or is a general partner of a commodity pool the operator of which is an exempt operator under Rule 4.13. The definition of IAC is narrower than it should be. For example, an IAC does not include a commodity trading advisor that is exempt from registration under Rule 4.14. An IAC must meet separation requirements, in that it must trade independently of the eligible entity and of any other IACs for the eligible entity and it must have no knowledge of trading decisions by any other IACs.

If an IAC is affiliated with the relevant eligible entity or another IAC, the exemption will be available only if additional separation requirements are satisfied. They include the written procedures to enforce the firewall arrangement, the trading through separately developed and independent trading systems, separate marketing of such trading systems and separate solicitation of funds by way of separate disclosure documents.

Assuming that proper firewalls are in place and other requirements are satisfied, the IAC exemption will permit disaggregation between proprietary positions of an eligible entity and positions managed by an IAC on behalf of client accounts of the eligible entity. Again, as stated in the Release, the IAC exemption will not permit disaggregation of accounts managed by different traders even if those traders operate under firewalls.

Other Exemptions

The Final Rule provides two additional exemptions. First, a person need not aggregate the positions or accounts of an owned equity if the ownership interest is based on the ownership of securities constituting the whole or part of an unsold allotment to or subscription by such person as a participant in the distribution of such securities by the issuer or by or through an underwriter; this exemption from aggregation does not require notice to the CFTC. Also, aggregation is not required if the sharing of information associated with such aggregation would violate federal law or regulations adopted thereunder and if the other person does not have actual knowledge of such information. Notice filed to obtain this exemption must include an opinion of counsel stating that the sharing of information would cause a violation of federal law or regulations adopted thereunder.

Obtaining Disaggregation Exemption

Under the Final Rule, to obtain an exemption from aggregation (including an IAC exemption), a trader must make a notice filing, which will become effective upon submission. This filing must describe the circumstances that warrant disaggregation and certify that they meet the relevant conditions for the exemption. In the event of a material change to the information provided in the notice, an updated or amended notice must promptly be filed detailing the material change. Upon call by the CFTC, any person claiming a disaggregation exemption must provide relevant information concerning the claim for exemption. Upon notice and opportunity to respond, the CFTC may amend, suspend, terminate, or otherwise modify the aggregation exemption.

Preexisting Positions

The Final Rule provides two exemptions for preexisting positions. First, traders are exempt from the non-spot-month position limits with respect to positions in Referenced Contracts that remain open and were entered into in good faith prior to the effective date of any rule, regulation, or order specifying a position limit under Part 151. There is no such exemption for spot-month limits. In addition, initial position limits established under Part 151 will not apply with respect to swap positions entered into in good faith before the effective date of such limits. Such swap positions may be netted with post-effective date swaps in applying any position limits. The Final Rule limits swap risk management exemptions granted under CFTC Rule 1.47 to swap positions that were entered into on or prior to the effective date of the initial position limits established under the Final Rule.

POSITION VISIBILITY

The Final Rule requires a person that holds or controls, separately or in continuation, on a net long or net short basis, positions in energy and metal Referenced Contracts in all months or in any single month in excess of certain thresholds to comply with position visibility reporting requirements. Position visibility levels are lower than the non-spot-month position limits. These position visibility reports will be required quarterly, but only during quarters in which such person exceeds the relevant level. The position visibility rule will become effective on the date that the new spot-month limits become effective.

SEVERABILITY

The Final Rule provides that if any provision of Part 151 or the application of any such provision to any person or circumstances is held invalid by a court, such invalidity shall not affect other provisions or application of any provision to other persons or circumstances which may be given effect without the invalid provision or application. This provision was not part of the proposed rules.

* * *

Please feel free to contact us with any questions.

Byungkwon Lim
+1 212 909 6571
blim@debevoise.com

Emilie Hsu
+1 212 909 6884
ehsu@debevoise.com