CLIENT UPDATE

PROPOSED CFTC RULES ON POSITION LIMITS

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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 Commodity Futures Trading Commission (the "CFTC") to establish position limits on an aggregate basis for (1) futures and options contracts on agricultural and exempt commodities traded on or subject to the rules of a designated contract market ("DCM") and (2) contracts based on the same underlying commodity as such futures and option contracts, including (a) swaps listed for trading by a DCM or swap execution facility ("SEF"), (b) swaps that are not traded on a DCM, SEF or other registered entity but which are determined to perform or affect a "significant price discovery function" ("SPDF swaps") and (c) foreign board of trade ("FBOT") contracts that are price-linked to a DCM or SEF contract and made available for trading on the FBOT by direct access from within the United States.

On October 18, 2011, the CFTC adopted final rules on position limits for 28 exempt and agricultural commodity futures and options contracts and swaps that are economically equivalent to such contracts as Part 151 of its regulations (the "Regulations"). On May 30, 2012, the CFTC published proposed modifications to Part 151 addressing the policy for certain aspects of aggregation requirements in determining position limits.

However, on September 28, 2012, the U.S. District Court for the District of Columbia issued an order in *International Swaps and Derivatives Association v. United States Commodity Futures Trading Commission*[1] that generally vacated those final rules and remanded the matter to the CFTC. The District Court rejected the CFTC's contention that section 4a of the CEA unambiguously mandated the imposition of position limits without any finding that such limits are necessary "to diminish, eliminate, or prevent excessive speculation," and held that it was therefore required to remand the matter to the CFTC to "fill in the gaps and resolve the ambiguities."

On November 5, 2013, the CFTC voted to dismiss its appeal of the District Court's decision and approve revisions to Part 150 (and other related provisions) to incorporate a new set of proposed rules (the "Proposed Position Limits Rules") establishing position limits[2] for 28 exempt and agricultural commodity (*i.e.*, "physical commodity")[3] futures and option contracts and swaps that are economically equivalent to such contracts, updating certain relevant definitions, revising the exemptions from position limits (including for bona fide hedging) and extending and updating reporting requirements for persons claiming an exemption from these limits.[4] Additionally, the Proposed Position Limits Rules update certain existing Regulations, guidance and acceptable practices for compliance with DCM core principle 5 and SEF core principle 6 in respect of exchange-set position limits and position accountability levels.

Also on November 5, 2013, in a separate notice of proposed rulemaking, the CFTC proposed modifications to the aggregation provisions of Part 150 (the "Proposed Aggregation Rules") that are substantially similar to the aggregation modifications proposed to vacated Part 151.

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1 887 F. Supp. 2d 259 (D.D.C. 2012).

2 In the release accompanying the Proposed Position Limits Rules, the CFTC concluded that, in enacting the Dodd-Frank Act, Congress made a determination that position limits are necessary with respect to physical commodities. The CFTC also concluded that the CEA mandates that the CFTC impose position limits and that the CFTC need not make a necessity finding of its own. Nonetheless, "out of an abundance of caution," the CFTC included in the release, as a separate and independent basis for the Proposed Position Limits Rules, a preliminary finding that such limits are necessary to achieve its statutory purposes.

3 The Proposed Rules define "physical commodity" as any agricultural commodity (as defined in Regulation 1.3) or any exempt commodity (as defined in section 1a(20) of the CEA), as distinct from an "excluded commodity," which is defined in section 1a(19) of the CEA to include, among other things, an interest rate, exchange rate, currency, security, security index and the occurrence of any contingency beyond the control of the parties that is associated with a financial, commercial or economic consequence.

4 As part of the Proposed Position Limits Rules, the CFTC proposed appendices to the revised Part 150 that (1) provide guidance on the bona fide hedging exemption, (2) list Core Referenced Futures Contracts and commodities that would be substantially the same as a commodity underlying a Core Referenced Futures Contract for purposes of the proposed definition of "basis contract" and (3) describe and analyze 14 fact patterns satisfying the definition of "bona fide hedging position" and present the proposed position limit levels in tabular form.

If both the Proposed Position Limits Rules and the Proposed Aggregation Rules (collectively, the "Proposed Rules") are adopted, the proposed modifications to Part 150 in the Proposed Aggregation Rules would apply to all of the 28 futures and options contracts and the economically equivalent swaps covered by the Proposed Position Limits Rules. However, the CFTC may adopt the Proposed Aggregation Rules without adopting the Proposed Position Limits Rules.

The text of both Proposed Position Limits Rules is available at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister110513c.pdf. The text of the Proposed Aggregation Rules is available at: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-27339a.pdf.

As under the vacated Part 151, the Proposed Position Limits Rules limit the number of Referenced Contracts with respect to a particular Core Referenced Futures Contract (as defined below) held or controlled by a trader directly or by application of the aggregation rules, subject to specific exemptions. This update covers the scope of the term "Referenced Contract," limit levels, exemptions from limits, certain reporting requirements, the aggregation requirement and exemptions from aggregation, as proposed in the Proposed Rules.

REFERENCED CONTRACTS

The building blocks of the Proposed Rules are Referenced Contracts; the proposed position limits do not apply with respect to futures, options or swaps that are not Referenced Contracts.

The Proposed Rules define the term "Referenced Contract" to mean, on a futures equivalent basis with respect to a particular Core Referenced Futures Contract, (1) such Core Referenced Futures Contract and (2) a futures contract, options contract or swap (other than a guarantee of a swap,[5] a "basis contract" or a "commodity index contract" (each, as defined below)) that is directly or indirectly linked to, including being partially or fully settled on, or priced at a fixed differential to (a) the price of such Core Referenced Futures Contract or (b) the price of the same commodity underlying such Core Referenced

[5] Unlike vacated Part 151, the Proposed Rules include a clarification excluding a guarantee of a swap from the definition of Referenced Contract. In the Position Limits Release, the CFTC explains that this exclusion was necessary because, after Part 151 had been adopted, the CFTC adopted final product rules defining the term "swap" to include a guarantee of such swap, to the extent that a counterparty would have recourse to the guarantor in connection with the position.

Futures Contract for delivery at the same location or locations as specified in such Core Referenced Futures Contract.

Core Referenced Futures Contracts

Like the vacated Part 151, the Proposed Rules set forth 28 Core Referenced Futures Contracts.[6] They are on futures contracts traded on DCMs on specified 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. Any successor contract to a Core Referenced Futures Contract and any option that expires into outright positions in a Core Referenced Futures Contract are also Core Referenced Futures Contracts under the Proposed Rules. In the release accompanying the Proposed Position Limits Rules (the "Position Limits Release"), the CFTC states that it will continue to consider adding additional futures contracts (such as electricity futures) to the list of Core Referenced Futures Contracts in the future.

Other Referenced Contracts

The position limits set forth in the Proposed Rules also apply to a number of contract types with prices that are or should be closely correlated to the prices of the 28 Core Referenced Futures Contracts (*i.e.*, economically equivalent contracts), including: (1) "look-alike" contracts (*i.e.*, those that settle off of a Core Referenced Futures Contract and those that are based on the same commodity for the same delivery location as a Core Referenced Futures Contract); (2) contracts based on an index comprised of one or more prices for the same delivery location and in the same or substantially the same commodity underlying a Core Referenced Futures Contract and (3) "intercommodity spread contracts"[7] with two components, one or both of which are Referenced Contracts.

A basis contract is not subject to the proposed position limits. A basis contract is a cash-settled contract based on the difference in (1) the price of a Core Referenced Futures Contract or a commodity deliverable on a Core Referenced Futures Contract (whether at

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[6] "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, 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; and (4) Core Referenced Contracts in energy commodities: NYMEX Henry Hub Natural Gas, NYMEX Light Sweet Crude Oil, NYMEX NY Harbor ULSD and NYMEX RBOB Gasoline.

[7] The Proposed Rules define "intercommodity spread contract" as a cash-settled contract representing the difference between the settlement prices of a Referenced Contract and another contract that is based on a different commodity.

par, a fixed discount to par or a premium to par) and (2) the price, at a different delivery location or pricing point than that of the same Core Referenced Futures Contract, of a commodity deliverable on the same Core Referenced Futures Contract (whether at par, a fixed discount to par or a premium to par) (a "core commodity") or a commodity listed in Appendix B to Part 150 as "substantially the same" as such core commodity.[8] Appendix B lists commodities that are treated as substantially the same as a commodity underlying a given Core Referenced Futures Contract.[9]

A commodity index contract is also not subject to the proposed limits.[10] A commodity index contract is a contract (other than basis or spread contract) based on an index comprised of commodities that are not the same or substantially the same.

Spread contracts, which are not excluded from the Referenced Contract definition, include both "intercommodity spread contracts" and "calendar spread contracts" (*i.e.*, cash-settled agreements representing the difference between the settlement price of one or a series of contract months of an agreement and that of another contract month or series thereof for the same agreement).

LEVELS OF LIMITS

Spot-Month Limits

The Proposed Rules provide that no person may hold or control positions in physical-delivery and cash-settled Referenced Contracts in the "spot month," net long or net short, in excess of the level fixed for physical-delivery Referenced Contracts or in excess of the level fixed for cash-settled Referenced Contracts.

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8 For instance, 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 is not a Referenced Contract and is not subject to the limits.

9 The Proposed Rules expand the "basis contract" definition set forth in vacated Part 151, which targeted only the locational differential, to include certain quality differentials (*e.g.*, RBOB vs. 87 unleaded) in order to reduce the potential for excessive speculation. The CFTC is seeking comment on alternatives to the specification of quality standards for substantially the same commodity, such as a methodology to identify and define which differential contracts should be excluded from position limits. Specifically, the CFTC is considering expanding the definition of basis contract to include (1) any commodity priced at a differential to any of its products and by-products, (2) any product or by-product of a particular commodity, priced at a differential to another product or by-product of the same commodity or (3) for a particular commodity, any other commodities that are similar to that commodity.

10 The Proposed Rules include an anti-evasion provision stating that, for purposes of applying the position limits under the proposed Part 150, a commodity index contract used to circumvent position limits will be considered a Referenced Contract. In the Position Limits Release, the CFTC notes that Part 20 requires reporting entities to report commodity reference price data sufficient to distinguish between commodity index contract and non-commodity index contract positions in covered contracts and that the CFTC intends to rely on these data elements to distinguish data records subject to position limits from those that are excluded from such limits.

The "spot month" for physical-delivery contracts is the period beginning at the earlier of (1) the close of trading ("COT") on the trading day preceding the first day on which delivery notices can be issued to a DCM's clearing organization or (2) the COT on the trading day preceding the third-to-last trading day, until the contract is no longer listed for trading or available for transfer. This definition is consistent with the current spot month for each of the 28 Core Referenced Futures Contracts.

Similarly, the spot month for cash-settled contracts is the period beginning at the earlier of (1) the COT on the trading day preceding the period in which the underlying cash-settlement price is calculated or (2) the COT on the trading day preceding the third-to-last trading day, until the contract cash-settlement price is determined and published (unless such price is determined based on prices of a Core Referenced Futures Contract during the spot month for that Core Referenced Futures Contract, in which case the spot month for the cash-settled contract is that same spot month).

The Proposed Rules require a trader to calculate its position in the physical-delivery contract and the cash-settled contract separately under a separate set of spot month limits. Therefore, a trader may hold positions up to the relevant spot month limit in each type of contract with respect to a particular Core Referenced Futures Contract, but may not net across physical-delivery and cash-settled contracts for purposes of the spot-month limits.

Initial Levels

Under the Proposed Rules, the spot-month limits for the 28 Core Referenced Futures Contracts are initially set at the existing DCM-set levels for such contracts, which levels are listed in Appendix D to the proposed Part 150. If the Proposed Rules are adopted, these limits will be effective 60 days after the final rule is published in the Federal Register. Until that date, the nine legacy agricultural Referenced Contracts will remain subject to the existing position limits under the current Part 150, while non-legacy Referenced Contracts will only be subject to the limits imposed by DCMs.

In the Position Limits Release, the CFTC states that, as an alternative to the initial spot-month limits in proposed Appendix D to Part 150, the CFTC is considering (and is requesting comment on the possibility of) setting the initial spot-month limits based on 25% of "estimated deliverable supplies" for various exchanges submitted by the CME Group ("CME") in correspondence dated July 1, 2013, if verified by the CFTC.[11] If the

[11] The spot-month limits based on CME's estimated deliverable supplies are set forth in Table 9 in the Position Limits Release. In general, the term "deliverable supply" 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 to long traders at its market value in normal cash marketing channels at the derivative contract's delivery points during

CFTC is unable to verify that an exchange's estimated deliverable supply for any commodity is reasonable, the CFTC may adopt the initial spot-month limits in proposed Appendix D for such commodity, or such higher level based on the CFTC's estimated deliverable supply for such commodity, but not greater than would result from the exchange's estimate.

The CFTC is also considering (and requesting comment on) a third alternative under which the CFTC is permitted, in its discretion, for purposes of setting an initial spot-month limit and subsequent resets, to use the recommended level, if any, of the spot-month limit as submitted by each DCM listing a Core Referenced Futures Contract (if lower than 25% of estimated deliverable supply).

Subsequent Levels and Procedures for Computing Future Levels

The Proposed Rules provide that the CFTC will fix subsequent levels of position limits (rounded to the nearest hundred contracts) in accordance with the procedures set forth below:

- At least once every two calendar years,[12] the CFTC will fix the level of the spot-month limit (for both physical-delivery and cash-settled contracts) at no greater than 25% of the estimated spot-month deliverable supply in the relevant Core Referenced Futures Contract, as provided by the relevant DCM or as determined by the CFTC.[13]
- Each DCM must submit to the CFTC an estimated spot-month deliverable supply by January 31 (for energy commodities), March 31 (for metal commodities), May 31 (for legacy agricultural commodities), or August 31 (for other agricultural commodities) of the second calendar year following the most recent CFTC action establishing such limit levels.

The Proposed Rules require the CFTC to publish subsequent position limits on its website. Subsequent limits will apply beginning on the close of business of the last business day of the second complete calendar month after such publication, except that if that date occurs in a spot month of a Core Referenced Futures Contract, the subsequent spot-month level will apply beginning with the next spot month for that contract.

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the specified delivery period, barring abnormal movement in interstate commerce." The term "estimated deliverable supply" means the amount of a commodity that can reasonably be expected to be readily available to short traders to make delivery at the expiration of a futures contract.

[12] Unlike vacated Part 151, which required annual updates to spot-month limits for agricultural contracts, the Proposed Rules require only biannual updates to the limits for such contracts.

[13] In the Position Limits Release, the CFTC states that the use of 25% of deliverable supply in setting spot-month limits is consistent with DCM core principle 5.

Non-Spot-Month Limits

The Proposed Rules also impose "single-month" and "all-months-combined" (collectively, "non-spot-month") position limits. Single-month limits indicate the maximum number of net long or net short positions a trader may hold in a Referenced Contract in a single month (other than the spot month). With respect to non-spot-month limits, a trader is permitted to net across physical-delivery Referenced Contracts and cash-settled Referenced Contracts in the same commodity. All-months-combined limits establish the maximum number of positions a trader may hold in a Referenced Contract in all trading months, including the spot month. The Proposed Rules set a single level for both single-month and all-months-combined limits.

The Proposed Rules provide that at least once every two calendar years, the CFTC will fix the level, for each Referenced Contract, of the single-month limit and the all-months-combined limit. Non-spot-month limits and all-months-combined limits are equal to 10% of the estimated average open interest in Referenced Contracts, up to 25,000 contracts, with a marginal increase of 2.5% of the open interest thereafter.[14]

Initial Levels

For setting the levels of initial non-spot-month limits, the CFTC proposes to use open interest for calendar years 2011 and 2012 in futures contracts, options thereon and in SPDF swaps that are traded on exempt commercial markets.[15] In the Position Limits Release, the CFTC notes that this formula will result in non-spot-month position limits that are high compared to the size of positions typically held in futures contracts and that the proposed initial non-spot-month limits represent the lower bounds for the initial levels the CFTC may establish in final rules.

The Position Limits Release states that the CFTC is considering using Part 20 data (should it determine such data to be reliable) in order to establish higher initial levels in a final rule and is also considering using SDR data, as practicable. In either case, the CFTC is considering excluding inter-affiliate swaps since such swaps tend to inflate open interest.

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[14] Under the Proposed Rules, the CFTC will estimate the average open interest in Referenced Contracts based on the largest annual average open interest computed for each of the past two calendar years, using either month-end open contracts or open contracts for each business day in the time period, as the CFTC deems reliable. The Proposed Rules require the CFTC to estimate average open interest using: (1) for options listed on a DCM, data reported to the CFTC pursuant to Part 16 (*e.g.*, option deltas) and (2) for swaps (on a futures equivalent basis), either (a) the economically equivalent amount of Core Referenced Futures Contracts reported pursuant to Part 20 or (b) data obtained by the CFTC from swap data repositories collecting data pursuant to Part 45.

[15] *See* Table 10 in Position Limits Release.

Subsequent Levels

For setting subsequent levels of non-spot-month limits, the CFTC proposes to estimate average open interest in Referenced Contracts using data reported by DCMs and SEFs pursuant to Parts 16, 20 and/or 45. The CFTC also proposes to use comprehensive positional data on physical commodity swaps (once such data is collected by SDRs under Part 45) and to convert such data to futures-equivalent open positions in order to fix numeral position limits through the application of the proposed open-interest-based formula. The CFTC proposes to publish such estimates of average open interest in Referenced Contracts on a monthly basis.

Grandfather of Pre-Existing Positions

The Proposed Rules conditionally exempt from single-month or all-months-combined position limits any derivatives contract acquired by a person in good faith prior to the effective date of any bylaw, rule, regulation or resolution specifying an initial position limit or a subsequent change to that limit (a "pre-existing position"). Nonetheless, the Proposed Rules provide that such a preexisting position (other than a "pre-enactment" or "transition period swap") will be taken into account in determining whether the person complies with Part 150, when the person's position in such contract has increased after the effective date of such limit.

The Proposed Rules provide that a pre-existing position other than a pre-enactment or transition period swap will be subject to the relevant spot-month limits.

A "pre-enactment swap" is any swap entered into prior to July 21, 2010 (the date of enactment of the Dodd-Frank Act) and still outstanding as of such date. A "transition period swap" is any swap entered into during the period commencing after such enactment date and ending 60 days after the publication in the Federal Register of final amendments to Part 150.[16]

Positions on Foreign Boards of Trade

As required under section 4a of the CEA, the Proposed Rules provide that a person with positions in Referenced Contracts executed on or pursuant to the rules of an FBOT is subject to the position limits if:

- such contracts settle against any price (including the daily or final settlement price) of one or more contracts listed for trading on a DCM or SEF ("linked contracts"); and

16 Pre-enactment and transition period swaps are exempted from the position limits, as discussed below.

- the FBOT makes available such Referenced Contracts to its members or other participants located in the United States through direct access to its electronic trading or other matching system (“direct-access contracts”).

Application of Position Limits to Trade Options

The Proposed Rules make conforming changes to the trade option exemption[17] set forth in Regulation 32.3 to clarify that the position limits apply to a commodity option that qualifies as a trade option to the same extent as such limits would apply to any other swap.

BONA FIDE HEDGING AND OTHER EXEMPTIONS

Bona Fide Hedging Exemption

Generally

Section 4a(c)(1) of the CEA exempts bona fide hedging transactions or positions from any position limits rules. The definition of bona fide hedging under section 4a(c)(2) of the CEA generally follows that under Regulation 1.3(z)(1), with certain differences.

Section 4a(c)(2) of the CEA requires the CFTC to adopt rules defining bona fide hedging transaction or position to include a “pass-through swap offset” (as defined below).

Also, the same section of the CEA clarifies that a bona fide hedging transaction or position (other than a pass-through swap offset) must represent a substitute for a physical market transaction.[18]

The Proposed Rules implement section 4a(c)(1) of the CEA by exempting from the position limits in the proposed Part 150 any “bona fide hedging positions” as defined in such part (subject to certain recordkeeping and reporting requirements and a proviso regarding “anticipatory bona fide hedge positions,” discussed below). The Proposed Rules replace the current bona fide hedging definition in Regulation 1.3(z) with a new definition.

The Proposed Rules define “bona fide hedging position” as any position (1) whose purpose is to offset price risks incidental to commercial cash, spot or forward operations

[17] The conditions for qualifying for a “trade option” under Regulation 32.3(a) are described in our previous client memorandum, “CFTC Final Rules on Commodity Options” (Apr. 20, 2012), available at http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=4abcb79f-f47a-42d6-a8fa-aa50c31da17f.

[18] While Regulation 1.3(z)(1) states that bona fide hedging transactions “normally” represent a substitute for physical market transactions, it does not explicitly require that this be the case, as section 4a(c)(2) does.

and (2) which is established and liquidated in an orderly manner[19] in accordance with sound commercial practices.

For a position in a "commodity derivative contract"[20] in a physical commodity to be a bona fide hedge, the position must either:

- Qualify as a "pass-through swap or pass-through swap offset" ***OR***
- Satisfy each of the following four conditions:
  - 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;
  - be economically appropriate[21] to the reduction of risks[22] in the conduct and management of a commercial enterprise (taking into account, generally, all inventory or products owned or controlled, or contracted for purchase or sale at a fixed price, by the hedger);
  - arise from a potential change in the value of (a) assets a person currently owns, produces, manufactures, processes or merchandises or anticipates owning, producing, manufacturing, processing or merchandising; (b) liabilities a person owes or anticipates incurring; or (c) services a person provides, purchases or anticipates providing or purchasing; and
  - qualify as one of eight enumerated bona fide hedging transactions or as a "cross-commodity hedge" under the Proposed Rules.

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[19] The CFTC notes that the proposed "orderly trading requirement" is intended to impose a duty of ordinary care. The CFTC proposes to evaluate whether such conduct is "orderly" under a negligence standard based on information available at the time of the trading or conduct. The Proposed Rules would characterize an orderly market as one exhibiting a rational relationship between consecutive prices, a correlation between price changes and the volume of trades, levels of volatility that do not dramatically reduce liquidity, accurate relationships between the price of a derivative and the underlying and reasonable spreads for contracts for near months and for remote months.

[20] The Proposed Rules define "commodity derivative contract" as a futures, option or swap contract in a commodity (other than a security futures product as defined in section 1a(45) of the CEA).

[21] The CFTC notes, by way of example, that a manufacturer may anticipate using a commodity it does not own as an input but may expect to change output prices to offset a change in the input commodity price. Under such circumstances, the CFTC states that it would be economically appropriate for the processor to offset the price risks of both the unfilled anticipated requirement for the input and the unsold anticipated production. See discussion of "manner of reporting" under proposed Part 19 below for more information on the "economically appropriate" test.

[22] In the Position Limits Release, the CFTC affirms that gross hedging may be appropriate under certain circumstances, when net cash positions do not measure total risk exposure due to differences in the timing of cash commitments, the location of stocks and differences in grades or types of the cash commodity being hedged.

Enumerated Bona Fide Hedging Transactions

The following positions are enumerated bona fide hedging positions:[23]

- Hedges of inventory and cash commodity purchase contracts: Short positions in commodity derivative contracts that do not exceed in quantity ownership or fixed-price purchase contracts in the contract's underlying cash commodity by the same person.[24]
- Hedges of cash commodity sales contracts:[25] Long positions in commodity derivative contracts that do not exceed in quantity (1) the fixed-price sales contracts in the contract's underlying cash commodity by the same person and (2) the quantity equivalent of fixed-price sales contracts of the cash products and by-products of such commodity by the same person. The CFTC clarifies that such long positions may be held in the spot month in a physical-delivery contract if economically appropriate.
- Hedges of unfilled anticipated requirements: The following positions, so long as such positions, during the lesser of the last five days of trading or the time period for the spot month in such physical-delivery contract, do not exceed the person's unfilled anticipated requirements of the same cash commodity for that month and for the next succeeding month:
  - Anticipated use by the same person: Long positions in commodity derivative contracts that (a) do not exceed in quantity unfilled anticipated requirements of the same cash commodity and (b) for agricultural commodities only, do not exceed 12 months, for processing, manufacturing or use by the same person;
  - Anticipated use by utility's customers: Long positions in commodity derivative contracts that do not exceed in quantity unfilled anticipated requirements of the same cash commodity for resale by a utility that is required or encouraged to hedge

23 The list of enumerated hedging positions in the Proposed Rules applies to all commodity derivative contracts (*i.e.*, futures, options thereon, swaps and direct-access linked FBOT contracts). Table 4 in the Position Limits Release provides a summary comparison of the various provision of the Proposed Rules, vacated Part 151 and the current rules under Regulation 1.3(z). Appendix B provides examples illustrating the enumerated bona fide hedges.

24 The CFTC clarifies that a person may use a commodity derivative contract to hedge inventories of a cash commodity deliverable on that contract even if such inventory is not in a delivery location, though a DCM or SEF may require that the person demonstrate its ability to move the commodity into a deliverable location, particularly during a spot month. The CFTC notes that, once the inventory is sold, the person would have a commercially reasonable time period (generally, less than one business day) to liquidate a position in excess of the position limits.

25 The CFTC declined to re-propose a hedge for unfilled storage capacity that was included in vacated Part 151. That exemption would have permitted a person to establish as a bona fide hedge, to the extent of the person's current or anticipated amount of unfilled storage capacity, offsetting sales and purchases of derivative contracts that did not exceed in quantity the amount of the same cash commodity that was anticipated to be merchandized.

by its public utility commission ("PUC") on behalf of its customers' anticipated use.[26]

- Hedges by agents: Long or short positions in commodity derivative contracts by an agent who does not own or has not contracted to sell or purchase the offsetting cash commodity at a fixed price, so long as the agent (1) is responsible for merchandising the cash positions being offset and (2) has a contractual arrangement with the owner of the commodity or holds the cash market commitment being offset.
- Hedges of unsold anticipated production: Short positions in commodity derivative contracts that (1) do not exceed in quantity unsold anticipated production of the same commodity and (2) for agricultural commodities only, do not exceed 12 months of production for the agricultural commodity by the same person, except that such a position will not constitute an enumerated bona fide hedging position during the lesser of the last five days of trading or the time period for the spot month in such physical-delivery contract (the "five-day rule").[27]
- Hedges of offsetting unfixed-price cash commodity sales and purchases: Subject to the five-day rule, short and long positions in commodity derivative 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 in the same commodity derivative contract; or
  - basis different commodity derivative contracts in the same commodity, regardless of whether the contracts are in the same calendar month.[28]
- Hedges of anticipated royalties: Subject to the five-day rule, short positions in commodity derivative contracts offset by the anticipated change in value of mineral

[26] This provision effectively grants Request Six of the Working Group Petition (as defined below).

[27] The CFTC is considering relaxing the five-day rule to permit a person to hold a position in a physical-delivery commodity derivative contract, other than an agricultural commodity, through the close of the spot month that does not exceed in quantity the reasonably anticipated unsold forward production that would be available for delivery under such contract. Specifically, the CFTC might permit the exchange listing the contract to administer exemptions to the five-day rule upon application to such exchange specifying unsold forward production that could be moved into delivery position.

[28] In the Proposing Release, the CFTC notes that a commercial enterprise may enter into such a transaction to reduce the risk arising from either (or both) a location differential or a time differential in unfixed price purchase and sale contracts in the same cash commodity but that, in the case of location differentials and where each of the underlying transactions in separate contracts may be in the same contract month, a position in a basis contract would not be subject to the position limits. However, the CFTC states that upon fixing the price of, or taking delivery on, the purchase contract, the owner of the cash commodity may hold the short leg of the spread as a hedge against a fixed-price purchase or inventory, but the long leg of the spread would no longer qualify as a bona fide hedge. Similarly, if the entity first fixed the price of the sales contract, the long leg of the spread may be held as a hedge against a fixed-price sale but the short leg would no longer qualify as a bona fide hedge.

royalty rights that are owned by the same person, so long as such rights arise out of the production of the mineral commodity (*e.g.*, oil, gas) underlying such contract.[29]

- Hedges of services: Subject to the five-day rule, short or long positions in commodity derivative 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, so long as the services contract arises out of the production, manufacturing, processing, use or transportation of the commodity underlying the commodity derivative contract, which may not exceed one year for agricultural commodities.[30]

The Proposed Rules provide a bona fide hedging exemption for positions in certain commodity derivative contracts that are used to offset the risks arising from a commodity other than the same cash commodity underlying the derivative contract, so long as the fluctuations in value of such position (or the commodity underlying such contract) are "substantially related" to the fluctuations in value of the actual or anticipated cash position or "pass-through swap."[31] This "cross-commodity hedge exemption" is subject to the five-day rule and applies only to: (1) each of the contracts listed above (in the discussion of enumerated bona fide hedges) and (2) "pass-through swap offsets" (as defined below).

In the Position Limits Release, the CFTC provides guidance on the proposed "substantially related" test. This safe harbor has two factors, one qualitative and one quantitative. The qualitative factor requires that the target commodity have a reasonable commercial relationship to the commodity underlying the commodity derivative contract (*e.g.*, grain and corn). The quantitative factor requires that the position in the commodity derivative contract offsetting a target commodity provide a reasonable quantitative correlation (in light of available liquid commodity derivative contracts).[32]

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[29] The CFTC notes that a royalty arises as "compensation for the use of property . . . [such as] natural resources, expressed as a percentage of receipts from using the property or as an account per unit produced" and that this exemption is thus limited to instances in which the royalty rights arise from the production of the commodity, and not the manufacturing, processing, use or transportation of the commodity.

[30] For instance, under this exemption, crop insurance providers and other agents that provide services in the physical marketing channel could qualify for a bona fide hedge of their contracts for services arising out of the production of the crop underlying a commodity derivative contract.

[31] In order for a position to qualify for this exemption, it must satisfy each of the other conditions applicable to enumerated bona fide hedging transactions.

[32] The CFTC notes that it will presume an appropriate quantitative relationship exists when the correlation (R) between first differences or returns in daily spot price series for the target commodity and the price series for the commodity underlying the derivative contract or for the derivative contract itself is at least 0.80 for a time period of at least 36 months. Additionally, the CFTC clarifies that, while a position in a commodity derivative contract that does not meet the safe harbor will be presumed to not be a bona fide cross-commodity hedging position, this presumption may be rebutted by demonstrating that reasonable relationship between the spot price series for the commodity to be hedged and either the spot price series for the commodity underlying the derivative contract or the price series for the

Pass-Through Swaps and Pass-Through Swaps Offsets

Under the Proposed Rules, a position that reduces risks attendant to a "pass-through swap" that was executed opposite a "pass-through swap counterparty" may qualify for the bona fide hedging exemption to the extent the offsetting position (the "pass-through swap offset") reduces such risks, subject to the five-day rule.

For a position to qualify as a "pass-through swap offset" under the Proposed Rules, the position must reduce risks attendant to a swap (the "pass-through swap") in the same physical commodity that was executed opposite a counterparty eligible, at the time of the transaction, to claim the bona fide hedging exemption with respect to the position by relying on one of the eight enumerated hedge exemptions or the cross-commodity hedge exemption (a "pass-through swap counterparty").

The Proposed Rules also clarify that the pass-through swap position itself would qualify as a bona fide hedging position to the extent it is offset.[33]

The Proposed Rules permit netting of positions in futures, futures options and economically equivalent swaps and direct-access linked FBOT contracts in the same Referenced Contract for purposes of the single-month and all-months-combined position limits. Thus, the pass-through swap exemption would not be necessary for a swap portfolio in Referenced Contracts that would automatically be netted with futures and futures options in the same contract outside of the spot month during which the pass-through swap exemption is not available in any case. However, the CFTC clarifies that a party entering into a cross-commodity pass-through swap offset with a pass-through swap counterparty may claim the exemption.

Working Group Petition

On January 20, 2012, the Working Group of Commercial Energy Firms (the "Working Group") filed a petition under section 4a(7) of the CEA (the "Working Group Petition")[34] in

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derivative contract itself. The CFTC also notes that a person should consider whether there is an actively traded commodity derivative contract that would meet the safe harbor, in light of liquidity considerations.

33 In other words, the non-bona-fide counterparty (*i.e.*, the party that is not a pass-through swap counterparty), which will generally be a dealer, may classify a pass-through swap as a bona fide hedge only if it enters into risk-reducing positions with respect to the risk attendant to the pass-through swap. For instance, if a person enters a pass-through swap opposite a pass-through swap counterparty that results in a directional exposure of 100 long positions in a Referenced Contract, that person may treat those 100 long positions as a bona fide hedge only if (and to the extent that) he also enters into 100 short positions to reduce the risk arising from the pass-through swap.

34 The Working Group Petition is available at: http://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/wgbfhpetition012012.pdf. The Working Group supplemented the petition in a letter dated April 17, 2012, available at http://www.cftc.gov/sttellent/groups/public/@rulesandproducts/documents/ifdocs/workinggroupltr041712.pdf.

which it made 10 requests for exemptions under vacated Part 151. The Position Limits Release includes the CFTC's proposed action on the Working Group Petition and requests comment on such proposed action. A summary of each request and the CFTC's proposed action is attached as Appendix A to this update.

Other Exemptions

In addition to the bona fide hedging exemption, the Proposed Rules provide several additional exemptions from position limits. They are set forth below.

Financial Distress Exemption

The Proposed Rules provide that, upon specific request made to the CFTC, the CFTC may exempt a person or related persons under financial distress circumstances for a time certain from any of the position limits requirements in the new Part 150, subject to certain recordkeeping and reporting requirements set forth below. Financial distress circumstances include situations involving the potential default or bankruptcy of the requesting person(s)' customer, affiliate or potential acquisition target (*e.g.*, customer default at a futures commission merchant ("FCM")).

Conditional Spot-Month Limit Exemption

The Proposed Rules provide a conditional spot-month limit exemption permitting traders to acquire positions up to (but not exceeding) five times the spot-month limit if such positions are exclusively in cash-settled Referenced Contracts. This conditional exemption would only be available to traders who do not hold or control positions in the spot-month physical-delivery Referenced Contract.[35]

As an alternative to this proposed exemption, the CFTC is considering whether to restrict a trader claiming the conditional spot-month limit exemption to positions in cash-settled contracts that settle to an index based on cash-market transaction prices, thereby prohibiting traders from claiming a conditional exemption if they hold positions in the spot month of cash-settled contracts that settle to prices based on the underlying physical-delivery futures contract.

The CFTC is also considering, as a second alternative, setting an expanded spot-month limit for cash-settled contracts at five times the level of the limit for the physical-delivery

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[35] The CFTC notes that since spot-month limit levels for cash-settled Referenced Contracts will be set at no more than 25% of the estimated spot-month deliverable supply in the relevant Core Referenced Futures Contract, this exemption permits a speculator to own positions in cash-settled Referenced Contracts equivalent to no more than 125% of the estimated deliverable supply.

Core Referenced Futures Contract, regardless of positions in the underlying physical-delivery contract. The CFTC notes that this alternative would not prohibit a trader from carrying a position in the spot month of the physical-delivery contract.

Finally, as a third alternative, the CFTC is considering limiting application of an expanded spot-month limit to a trader holding positions in cash-settled contracts that settle to an index based on cash-market transactions prices. Under this alternative, cash-settled contracts that settle to the underlying physical-delivery contract would be restricted by a spot-month limit set at the same level as that of the underlying physical-delivery contract, while an aggregate spot-month limit on all types of cash-settled contracts would be set at five times the level of the limit of the underlying physical-delivery contract.

Eligible Affiliates

An "eligible affiliate" is not required to comply separately with the position limits set forth in the Proposed Rules. "Eligible affiliate" is defined as an entity with respect to which another person:

- directly or indirectly holds either: (1) a majority of the equity securities of such entity or (2) the right to receive upon dissolution of, or the contribution of, a majority of the capital of such entity;
- reports its financial statements on a consolidated basis under GAAP or International Financial Reporting Standards and such financial statements include the financial results of such entity; and
- is required to aggregate the positions of such entity under Regulation 150.4 and does not claim an exemption from aggregation for such entity.

Pre-enactment and Transition Period Swaps Exemption

The Proposed Rules exempt positions acquired in good faith in any pre-enactment or transition period swap from the position limits set forth in the new Part 150. However, the Proposed Rules allow both pre-enactment and transition swaps to be netted with "post-effective date" commodity derivative contracts (*i.e.*, contracts acquired more than 60 days after publication of a final rule implementing this exemption) for the purpose of complying with any non-spot-month position limit.

Guidance on Seeking Exemptions for Non-Enumerated Risk-Reducing Transactions

The Proposed Rules revoke Regulation 1.47 for seeking approval for a non-enumerated exemption and provide that any person engaging in risk-reducing practices commonly

used in the market, which they believe may not be specifically enumerated in the new "bona fide hedging position" definition may request: (1) an interpretative letter from CFTC staff under Regulation 140.99 concerning the applicability of such exemption or (2) exemptive relief from the CFTC under section 4a(a)(7) of the CEA.[36] The Proposed Rules guide market participants to first consult proposed Appendix C to Part 150 to see whether their practices fall within a non-exhaustive list of examples of bona fide hedging positions.

Previously Granted Exemptions

Under the Proposed Rules, all swap risk-management exemptions previously granted by the CFTC under Regulation 1.47 do not apply to swap positions entered into after the effective date of a final position limits rulemaking. In other words, if adopted, the Proposed Rules will revoke all previously granted exemptions as applied to new swap positions.

In the Position Limits Release, the CFTC acknowledges that certain transactions and positions that are currently exempt from position limits may be subject to such limits once the Proposed Rules are finalized since these exemptions are inconsistent with the proposed definition of bona fide hedging positions.[37] The CFTC notes, however, that the effect of revoking these exemptions for intermediaries may be mitigated in part by the absence of class limits in the proposed rules, since traders will be able to net long and short positions in economically equivalent Referenced Contracts (*i.e.*, futures against swaps) outside of the spot month.

Recordkeeping Requirements

The Proposed Rules specify recordkeeping requirements for persons claiming the bona fide hedging exemption, the financial distress positions exemption, the conditional spot-month limit exemption or any other exemption granted by the CFTC in an interpretative letter or exemptive letter. Specifically, under the Proposed Rules, any person relying on such an exemption must keep and maintain complete books and records concerning all

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[36] The CFTC has provided a non-exhaustive list of examples of bona fide hedging positions in proposed Appendix C to the new Part 150.

[37] For instance, the CFTC notes that some pre-Dodd-Frank Act exemptions recognized offsets of risks from financial products but that, since financial products are not substitutes for positions taken or to be taken in a physical marketing channel, exempting positions offsetting such risks is inconsistent with the new bona fide hedging definition for physical commodities. Additionally, many pre-Dodd-Frank Act exemptions provided relief for persons acting as intermediaries in connection with index trading activities. For example, where a pension fund enters into a swap with a swap dealer to receive a rate of return on a particular commodity index and the swap dealer pays the rate of return on the index to the pension fund and purchases futures to hedge its short exposure to the index, the swap dealer might have obtained a bona fide hedge exemption for this position prior to the Dodd-Frank Act but will no longer be entitled to rely on such an exemption.

details of their related cash, forward, futures, futures options and swap positions and transactions, including anticipated requirements, production and royalties, contracts for services, cash commodity products and by-products and cross-commodity hedges, and must make such books and records (including a list of pass-through swap counterparties) available to the CFTC upon request.

Additionally, any party relying on an exemption for pass-through swaps or pass-through swap offsets in order to exceed position limits must receive from the pass-through swap counterparty a written representation (*e.g.*, in a trade confirmation) that, as to such counterparty, the swap qualifies in good faith as a bona fide hedging position at the time it was executed. That representation must be retained by the parties for at least two years after the swap expires and furnished to the CFTC upon request. Additionally, the party making the representation must keep and make available to the CFTC upon request all books and records supporting the representation for at least two years following the swap's expiration.

The Proposed Rules require, upon request by the CFTC, the Director of the Division of Market Oversight or the Director's delegee, any person claiming one of the relevant exemptions to provide the CFTC such information as specified in the request relating to (1) the positions owned or controlled by that person, (2) trading done pursuant to the claimed exemption and (3) the derivative contracts or cash market positions and the relevant business relationships supporting the claim of exemption.

Reporting Requirements

The Proposed Rules amend the current reporting requirements under Part 19 for persons holding or controlling reportable futures and option positions constituting bona fide hedge positions under Regulation 1.3(z) and for merchants and dealers in cotton holding or controlling reportable futures positions in cotton. Under current Part 19, hedgers that hold positions in the markets that are currently subject to position limits (*i.e.*, those for grains, soy complex and cotton) must file monthly reports if such positions exceed the relevant limits. These reports—Form 204 (for cash positions in grains and soy complex) and Form 304 (for cash positions in cotton) (collectively, the "series '04 reports")—are used by the CFTC to determine whether a trader has sufficient cash positions to justify futures and option positions above the limits.[38]

[38] The Proposed Rules would retain Forms 204 and 304, which will feature only minor changes to the types of data to be reported.

The Proposed Rules amend Part 19 in several respects to conform it with the CFTC's proposed changes to Part 150.[39] Additionally, the Proposed Rules amend Part 19 by extending series '04 reporting requirements to any person claiming the bona fide hedging exemption, the financial distress positions exemption, the conditional spot-month limit exemption or any other exemption granted by the CFTC in an interpretative or exemptive letter.

The Proposed Rules do so by adding three new series '04 forms: (1) Proposed Form 504 (for persons claiming the conditional spot-month limit exemption),[40] (2) Proposed Form 604 (for person claiming the bona fide hedging exemption for either of two specific pass-through swap position types, discussed below)[41] and (3) Proposed Form 704 (for persons claiming the bona fide hedging exemption for certain anticipatory bona fide hedging positions).[42] Persons claiming the bona fide hedging exemption (other than with respect to certain anticipatory bona fide hedges), the financial distress exemption, the pre-enactment or transition swaps exemption or any other non-enumerated exemption are required, under the Proposed Rules, to file a Form 204.

The Proposed Rules require that series '04 reports be transmitted using the format, coding structure and electronic data transmission procedures approved in writing by the CFTC (or its designee) and that any information reported under Part 19 comply with the following conditions:

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[39] References to Regulation 1.3(z) are replaced with references to the proposed bona fide hedging definition in Part 150 and the phrase "futures and option positions" is replaced with "commodity derivative contracts."

[40] The Proposed Rules require persons relying on the conditional spot-month limit exemption to report certain information concerning their cash market activities for any commodity underlying a derivatives contract specially designated by the CFTC for reporting (in the Federal Register and on its Website). Initially, the CFTC proposes to require Form 504 reporting for exemptions in natural gas contracts only. As proposed, the filing must be made daily on the business day following each day that the person is over the spot-month limit.

[41] Under the Proposed Rules, a person must file a Form 604 if such person relies on the pass-through swap exemption for either of two position types of swaps—(1) swaps that are not Referenced Contracts for which the risk is offset with a Referenced Contract and (2) cash-settled swaps (whether Referenced Contracts or not) for which the risk is offset with a physical-delivery Referenced Contract in its spot month (or vice versa). The information to be reported in a Form 604 differs (*e.g.*, daily vs. monthly reporting) depending on the type of position held.

[42] The Proposed Rules impose reporting requirements on traders seeking an exemption from position limits for any of five enumerated anticipated hedging transactions listed in the bona fide hedging definition. The Proposed Rules require such traders to file an initial statement on Form 704 with the CFTC at least 10 days prior to the date that such positions would exceed the relevant position limits. The initial statement must provide a detailed description of the person's anticipated activity and the CFTC may reject all or a portion of the position as not meeting the bona fide hedging requirements. The CFTC may request additional specific information concerning the anticipated transaction to be hedged, but if a Form 704 filing meets the proposed requirements, it is effective 10 days after submission. Supplemental reports are required when a trader's anticipatory hedging needs increase beyond that in its most recent filing and annual updates must be provided detailing the trader's related cash market activities.

Cash Positions Exclusion: For purposes of reporting cash market positions under current Part 19, the CFTC has historically permitted a reporting person to "exclude certain products or byproducts in determining his cash positions for bona fide hedging" if it is "the regular business practice" of the reporting person to do so (the "Cash Positions Exclusion"). The Proposed Rules provide that the Cash Positions Exclusion is available only if the amount of the source commodity being excluded is *de minimis*, impractical to account for and/or on the opposite side of the market from the market participant's hedging position.

Cross-Commodity Hedges: The Proposed Rules provide that cash positions that represent a commodity, or products or byproducts of a commodity, that is different from the commodity underlying a commodity derivative contract used for hedging, must be shown both (1) in terms of the equivalent amount of the commodity underlying the contract used for hedging and (2) in terms of the actual cash commodity as provided for on the appropriate series '04 form.

Standards and Conversion Factors: The Proposed Rules maintain the requirement that standards and conversion factors used in computing cash positions for reporting purposes must be made available to the CFTC upon request.

EXCHANGE-SET POSITION LIMITS

Current Part 150 requires each exchange to set position limits on the purchase or sale of futures and options contracts (separately and in combination), other than contracts for which the CFTC imposes position limits in current Part 150 and futures or options on major foreign currencies. Additionally, current Part 150 presents explicit numeric formulas and descriptive standards for position limits on newly designated contracts (and for subsequent adjustments).

Prior to the Dodd-Frank Act, DCMs were permitted, under DCM core principle 1, to use their reasonable discretion in establishing the manner in which they comply with the core principles.[43] However, the Dodd-Frank Act amended DCM core principle 1 to explicitly provide the CFTC with discretion to mandate the manner in which boards of trade comply with the core principles, including DCM core principle 5, which requires DCMs to adopt position limits or position accountability levels[44] where necessary and appropriate to

[43] *See* CEA section 5(d)(1)(B); 7 U.S.C. § 7(d)(1)(B).

[44] Current Part 150 permits exchanges to substitute position accountability levels for position limits for physical commodity derivatives outside the spot month in high volume and liquid markets. Position accountability levels are not fixed limits, but rather position sizes that trigger an exchange review of a trader's position and at which an exchange may remediate perceived problems (for instance, forcing a trader to reduce his position).

reduce the threat of market manipulation or congestion. The Dodd-Frank Act also added SEF core principle 6, which parallels DCM core principle 5 by requiring SEFs to adopt position limits or accountability rules for each swap executed pursuant to their rules.

The Proposed Rules update and streamline the Part 150 regulations pertaining to exchange-set position limits by: (1) amending the existing regulations to include SEFs and swaps, (2) codifying rules and acceptable practices for compliance with DCM core principle 5 and SEF core principle 6 for contracts that are subject to position limits and (3) codifying rules and revising guidance and acceptable practices for compliance with DCM core principle 5 and SEF core principle 6 for contracts that are not subject to such limits.

Exchange-Set Position Limits for Contracts Subject to Federal Position Limits

The Proposed Rules implement the requirements of the Dodd-Frank Act[45] by specifying that a DCM or SEF that lists a commodity derivative contract that is subject to federal position limits[46] must adopt position limits for that contract at a level that is not higher than the federal limit. The Proposed Rules also clarify the types of spread positions for which a DCM or SEF may grant exemptions from the federal limits (*i.e.*, inter-market and intra-market spread positions must be outside of the spot month for physical delivery contracts, while intra-market spread positions must not exceed the federal all-months limit when combined with any other net positions in a single month). The Proposed Rules require traders to apply to the DCM or SEF for any exemption from its position limits and preserve the exchange's ability to limit bona fide hedging positions which it determines are not in accord with sound commercial practices or which are too large to be established and liquidated in an orderly fashion.

[45] DCM core principle 5 and SEF core principle 6, as amended by the Dodd-Frank Act, require that, for any contract that is subject to a position limit established by the CFTC pursuant to section 4a(a) of the CEA, the DCM or SEF (as applicable) must set the position limit at a level not higher than the CFTC's limit.

[46] The Proposed Rules require DCMs and SEFs to exempt from federal position limits any positions in pre-enactment or transition period swaps acquired in good faith, but permit netting of such a pre-existing positions with post-effective date derivative contracts for purposes of any non-spot-month position limit. Further, the Proposed Rules require DCMs and SEFs to exempt from non-spot-month federal position limits any derivative contract acquired in good faith prior to the effective date of such limit, but require that such pre-existing contract be attributed to the relevant person if his position is increased after such date.

Exchange-Set Position Limits for Contracts Not Subject to Federal Position Limits

Spot-Month Limits for Contracts Not Subject to Federal Position Limits

The Proposed Rules set forth certain procedures for a DCM or SEF to follow in calculating spot-month position limits for commodity derivatives contracts that are listed on a DCM or SEF but are not subject to position limits.

For a contract that is based on a commodity with a measurable deliverable supply, the initial spot-month limit must be established (at the time of the contract's initial listing) at a level that is no greater than 25% of the estimated spot-month deliverable supply (calculated separately for each month to be listed). The Proposed Rules provide that such limits should be reviewed at least once every two years and may be adjusted to a level no greater than that 25% threshold.

For contracts that are based on a commodity with no measurable deliverable supply, the spot-month limit must initially be set "at a level that is necessary and appropriate to reduce the potential threat of market manipulation or price distortion of the contract's or the underlying commodity's price or index" and should also be reviewed at least once every two years, but must not be adjusted to a level greater than necessary and appropriate to reduce the threat.

Non-Spot-Month Limits for Contracts Not Subject to Federal Position Limits

The Proposed Rules preserve the existing acceptable practice under current Part 150 whereby non-spot-month limits for agricultural commodity contracts that are not subject to the federal limits should be no greater than 1,000 contracts at initial listing and whenever the notional quantity per contract is no larger than a typical cash market transaction in the underlying commodity. Similarly, the Proposed Rules preserve the existing acceptable practice for DCMs to set non-spot-month limits at no greater than 5,000 contracts at initial listing and whenever the notional quantity per contract is no larger than a typical cash market transaction in the underlying commodity, but apply this acceptable practice on a wider scale to both exempt and excluded commodity derivative contracts.[47] Additionally, the Proposed Rules provide that if a commodity derivative contract is

[47] The Proposed Rules maintain the basic formula set forth in current Part 150 for adjusting non-spot-month limits, which is the same formula set forth in the Proposed Rules for adjusting federal non-spot-month limits.

substantially the same as a pre-existing DCM or SEF contract, then the DCM or SEF may adopt the same limit as applies to the pre-existing contract.[48]

Exemptions from DCM and SEF Limits for Contracts Not Subject to Federal Limits

The Proposed Rules require that any hedge exemption rules adopted by a DCM or SEF conform to the bona fide hedging definition in the Proposed Rules. Additionally, the Proposed Rules set forth acceptable practices for DCMs and SEFs to grant exemptions from position limits for positions, other than bona fide hedges, in contracts not subject to federal limits. Such exemptions generally track the exemptions from federal position limits discussed above. Also, the Proposed Rules permit a DCM or SEF to grant a limited risk management exemption for contracts on excluded commodities pursuant to rules submitted to the CFTC and consistent with the guidance in proposed Appendix A to Part 150.[49]

Position Accountability Rules for Contracts Not Subject to Federal Position Limits

The Proposed Rules update the existing acceptable practice for a DCM or SEF to adopt position accountability rules in lieu of position limits, under certain circumstances, for contracts that are not subject to federal position limits (including excluded commodity contracts), and authorize DCMs and SEFs to require traders to (1) provide information regarding their position when requested by the exchange and (2) consent to halt from increasing their position in a contract if so ordered and to reduce their position in an orderly manner.

The Proposed Rules maintain the acceptable practice for a DCM or SEF to adopt position accountability rules outside the spot month, in lieu of position limits, for an agricultural or exempt commodity derivative contract that (1) has an average month-end open interest of 50,000 contracts and an average daily volume of 5,000 or more contracts during the most recent calendar year; (2) has a liquid cash market; and (3) is not subject to federal position limits. However, such DCM or SEF is required under the Proposed Rules to adopt a spot-month limit no greater than 25% of the estimated spot-month deliverable supply.

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[48] Similarly, under the Proposed Rules, if a commodity derivative contract is cash-settled by referencing a daily settlement price of an existing contract listed on a DCM or SEF, the DCM or SEF may adopt the same position limits (spot month, single month and all months) as the original contract (if the contract sizes are the same).

[49] Under the Proposed Rules for federal position limits, in order for an excluded commodity position that is not an enumerated bona fide hedging position to qualify for a bona fide hedging exemption, the position must, in addition to satisfying the "economically appropriate" requirement, be recognized as a bona fide hedge by the DCM or SEF (pursuant to its rules submitted to the CFTC and consistent with the guidance in proposed Appendix A). Appendix A provides a non-exclusive list of risk management exemption positions, including (among others) (1) short calls on securities or currencies owned (*i.e.*, covered calls) and (2) long positions in asset allocation strategies covered by hedged debt securities or currencies owned (*i.e.*, unleveraged synthetic positions).

For an excluded commodity contract with a highly liquid cash market and no legal impediment to delivery, as well as excluded commodity contracts without a measurable deliverable supply, the Proposed Rules authorize DCMs and SEFs to adopt position accountability rules in the spot month in lieu of position limits. However, for all other excluded commodity contracts, the Proposed Rules provide that a DCM or SEF should adopt a spot-month position limit no greater than 25% of the estimated deliverable supply.

Finally, the Proposed Rules authorize DCMs and SEFs to list a new contract with position accountability levels in lieu of position limits if that new contract is substantially the same as an existing contract that is currently listed for trading on an exchange that has already adopted position accountability levels in lieu of position limits.

Exchanges Must Adopt Aggregation Rules

With respect to both commodity derivative contracts that are subject to federal position limits and those that are not subject to such limits, the Proposed Rules require DCMs and SEFs to have aggregation rules that conform to the federal aggregation standards set forth in Regulation 150.4 (discussed below).

PROPOSED AGGREGATION RULES

The CFTC's existing aggregation policy under current Regulation 150.4 generally requires that unless a particular exemption applies, a person must aggregate all positions it holds (directly or indirectly) or for which that it controls trading decisions with (1) all accounts or positions in which that person has a 10% or greater ownership or equity interest and (2) all positions held jointly by such person with another person (or persons) pursuant to an express or implied agreement or understanding (as if such positions were held solely by such person).

Positions To Be Aggregated: Control and Ownership

The Proposed Aggregation Rules maintain the general aggregation requirement in current Regulation 150.4, expanding it to cover all contracts subject to federal position limits under the Proposed Position Limits Rules (if adopted). Specifically, the Proposed Aggregation Rules provide that, for purposes of applying the position limits set forth in the Proposed Position Limits Rules, unless an exemption applies, the positions held and trading done by a person must be aggregated with all positions[50] in accounts (1) for which the person

[50] The Proposed Rules require that, where an owned entity's position is aggregated with the owner's positions, the entire position of the owned entity be included in determining whether the limits are exceeded (rather than aggregating *pro rata* based on the equity owner's interest). However, the CFTC is soliciting comment as to whether it should require

directly or indirectly controls[51] trading or (2) in which the person holds a 10% or greater ownership interest.

For purposes of determining the positions in accounts for which any person controls trading or holds a 10% or greater ownership or equity interest, positions or ownership or equity interests held by, and trading done or controlled by, two or more persons acting pursuant to an express or implied agreement or understanding must be treated the same as if the positions or ownership or equity interests were held by, or the trading were controlled by, a single person.

Moreover, consistent with the approach taken in the proposed amendments to vacated Part 151, the Proposed Rules amend Regulation 150.4 to require persons holding or controlling the trading of positions in more than one account or pool with "substantially identical trading strategies" to aggregate all such positions (the "Substantially Identical Trading Strategies Requirement").

Exemptions from Aggregation

The Proposed Rules provide several exemptions from the aggregation requirement, each of which is subject to the Substantially Identical Trading Strategies Requirement.

Exemption for Information Sharing Restriction

The Proposed Aggregation Rules include an exemption from aggregation where information sharing associated with aggregation could result in a violation of law. Specifically, the Proposed Aggregation Rules provide that a person need not aggregate the positions or accounts of a separately organized entity (an "owned entity") if the sharing of information associated with such aggregation (including, without limitation, information reflecting the transactions and positions of such person and the owned entity) creates a "reasonable risk" that either person could violate state[52] or federal law or the law of a foreign jurisdiction, or regulations adopted thereunder,[53] so long as the person does not

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only *pro-rata* aggregation (possibly subject to an additional requirement that the person to file a notice informing the CFTC of such person's ownership interest). Alternatively, given the administrative burdens associated with *pro rata* aggregation, the CFTC is considering providing for aggregation based on ownership tiers.

[51] Control is not defined under the Proposed Rules. 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.

[52] Unlike the proposed amendments to Part 151, the Proposed Rules do not require that a person show that a comparable federal law exists in order for a state law to be the basis for an exemption.

[53] The Proposed Rules provide that this exemption is not available where the law or regulation "serves as a means to evade the aggregation of accounts or positions."

have actual knowledge of such information. In the release accompanying the Proposed Aggregation Rules (the "Aggregation Rules Release"), the CFTC notes that this exemption is not available for potential violations of local or international law.

Prior to relying on this exemption, the Proposed Rules require that a person file a Notice of Exemption (as defined below) with the CFTC, along with a written legal memorandum (which may be prepared by an employee of the person or its affiliates) explaining in detail the basis for the conclusion that the information sharing creates such a risk.[54] The CFTC notes that where there is a reasonable risk that persons in general could violate a law of general applicability, the written legal memorandum may be prepared in a "general manner" (*i.e.*, not specific to the person providing the memorandum, such as a memo commissioned by a trade association) and may be provided by more than one person to satisfy the requirement, so long as it is clear from the memorandum how the risk applies to the person providing the memorandum.

Exemptions for Ownership of Less than 50% in an Owned Entity

In addition to the absolute exemption from the aggregation requirement for ownership or equity interests of less than 10%, the Proposed Rules establish a notice filing procedure, effective upon submission, to permit a person with either an ownership or an equity interest in an owned entity of 50% or less (but more than 10%) (other than an interest in a pooled account)[55] to disaggregate the positions of the owned entity in specified circumstances. In order to qualify for this conditional exemption from the aggregation requirement,[56] the person holding such an interest (including any entity such person must aggregate) and the owned entity:

- Must not have knowledge[57] of the trading decisions of the other;
- Must trade pursuant to separately developed and independent trading systems;[58]

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[54] This differs from the proposed amendments to Part 151 which required an opinion of counsel regarding the risk.

[55] The proposed Rules retain the aggregation requirement applicable to pooled accounts set forth in the current Part 150.

[56] The CFTC notes that seeking disaggregation relief is only one option for groups of affiliates that may exceed a limit in the aggregate but remain below the limit individually. Another option is adopting procedures to avoid exceeding the limits on an aggregate basis (*e.g.*, assigning each subsidiary of a holding company an internal limit).

[57] The CFTC clarifies that this criterion would generally not require aggregation based solely on knowledge a party obtains during execution of a transaction regarding the trading of its counterparty, nor would it encompass knowledge that an entity obtains when carrying out due diligence under a fiduciary duty (so long as such knowledge is not directly used to affect the entity's trading).

[58] The CFTC notes that this criterion will not prevent an owner and an owned entity from both using the same "off-the-shelf" system developed by a third party. Rather, the CFTC's concern is that trading systems could be used by multiple parties who each know that the other parties use the same system as well as the specific parameters used for trading and, therefore, indirectly coordinate their trading.

- Must have and enforce written procedures to preclude each entity from having knowledge of, gaining access to or receiving data about, trades of the other;[59]
- Must not share employees that control the trading decisions of either;[60] and
- Must not have risk management systems that permit the sharing of trades or trading strategies.[61]

Any person relying on this exemption must file a Notice of Exemption with the CFTC.

Exemption for Ownership of Greater than 50% in an Owned Entity

In limited situations, disaggregation relief may be available under the Proposed Rules even for persons with a majority ownership or equity interest in an owned entity. However, this "Majority Ownership Exemption" is not available merely upon a notice filing by the owner. Rather, in order for a person with a greater than 50% ownership or equity interest in an owned entity (other than a pooled account) to disaggregate the accounts or positions of the owned entity, the CFTC must find,[62] in its discretion, that each of the following conditions[63] are met:

- The owner must certify to the CFTC that the owned entity is not required under U.S. GAAP to be, and is not, consolidated on the owner's financial statement;[64]

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59 The Proposed Rules provide that such procedures must include document routing and other procedures or security arrangements, including separate physical locations, that maintain the independence of their activities. While the Proposed Rules would not necessarily require that the relevant personnel be located in separate buildings, the CFTC stresses that there must be a physical barrier between the personnel preventing access between personnel that would impinge on their independence. The CFTC states that locked doors with restricted access would generally be sufficient, while merely providing the "independent" personnel with desks of their own would not.

60 The CFTC notes that sharing of attorneys, accountants, risk managers, compliance and other mid- and back-office personnel between entities would generally not compromise independence so long as the employees do not control, direct or participate in trading decisions. Similarly, sharing of board or advisory committee members, research personnel or sharing of employees for training, operational or compliance purposes would not compromise independence so long as the personnel do not influence (*e.g.*, "have a say in") or direct trading decisions.

61 The CFTC notes, however, that this criterion is not intended to prohibit sharing of information used only for risk management and surveillance purposes, when such information is not used for trading purposes and not shared with employees that control, direct or participate in such decisions.

62 The CFTC clarifies that this proposed exemption is not automatic; rather, it would be available only if the CFTC finds, in its discretion, that all of the conditions are met. However, the CFTC stresses that these proposed criteria are not intended to impose requirements beyond their plain-language meaning. For instance, routine pre- or post-trade systems to effect trading on an operational level would not, generally, have to be independently developed in order to comply, and employees that do not participate in trading decisions would not be subject to the criteria.

63 The CFTC notes that the presence of certain additional factors will be interpreted favorably in granting majority owners relief from the aggregation requirement. These include: (1) the owned entity being a newly acquired standalone business or a joint venture subject to special restrictions on control or (2) two different owned entities conducting operations at different levels of commerce (*e.g.*, retail and wholesale).

64 The CFTC acknowledges that, for most entities, ownership of more than 50% of another entity's voting shares is the point at which consolidation of the owned entity on the owner's financial statements is required under GAAP.

- The owner (including any entity the owner must aggregate) and the owned entity (1) must not have knowledge of the trading decisions of the other and (2) must not have risk management systems that permit the sharing of trades or trading strategy;
- The owner must demonstrate to the CFTC that procedures are in place that are reasonably effective to prevent coordinated trading decisions by such person, any entity such person must aggregate and the owned entity (in spite of the majority ownership);
- Each representative (if any) of the owner on the owned entity's board of directors (or equivalent body) must certify that he does not control the owned entity's trading decisions;
- The owner must (1) certify to the CFTC either (a) that all of the owned entity's positions qualify as bona fide hedging transactions or (b) that any non-qualifying positions do not exceed 20% of any position limit current in effect and (2) agree with the CFTC that:
    - if such certification (the "Bona Fide Hedging Certification") becomes untrue for any of its owned entities, the owner will aggregate the accounts or positions of the owned entity with its other positions for three complete calendar months and, if all of the owned entity's positions qualify as bona fide hedging transactions during that time, the owner may make another certification and cease such aggregation;
    - any owned entity of the owner will, upon call by the CFTC, make a filing responsive to the call, reflecting only such owned entity's positions and transactions (and not reflecting the owner's inventory or any other accounts or positions the owner is required to aggregate); and
    - the owner will inform the CFTC (and provide any information the CFTC may request) if any of its owned entities engage in coordinated activity regarding the trading of the owner, the owned entity or any accounts or positions the owner is required to aggregate (even where the owner and the owned entity do not have knowledge of the trading decisions of the other and do not have risk management systems permitting sharing of trades or trading strategy).

In order to rely on the Majority Ownership Exemption, the Proposed Rules require that the owner, when first requesting such disaggregation, must file a formal request (a "Majority Ownership Exemption Request") with the CFTC (as discussed below), which will become effective if and when the CFTC finds that the foregoing conditions have been satisfied.

Therefore, the CFTC notes, if a person holds an equity or ownership interest above 50% in another entity, but does not hold a greater than 50% voting interest in the entity, this conditional exemption may be available. However, the CFTC notes that lack of financial consolidation is only one of the proposed factors to be considered by the CFTC and even if the owned entity is not consolidated and the other requirements are met, the CFTC may nonetheless determine that the relief is not appropriate.

Finally, the CFTC notes that if a person with greater than 50% ownership of an owned entity cannot meet the foregoing conditions, that person could apply to the CFTC for relief from aggregation under section 4a(a)(7) of the CEA, stating the facts justifying relief.

Exemptions for Accounts Carried by an Independent Account Controller

The Proposed Rules include an exemption from aggregation for the client positions or accounts of an "eligible entity"[65] carried by an authorized "independent account controller"[66] ("IAC"). Specifically, the Proposed Rules provide that an eligible entity need not aggregate its positions with its client positions or accounts carried by an authorized IAC, except for the spot month in physical-delivery contracts, so long as the IAC does not exceed the federal limits. To rely on this exemption, the eligible entity must deliver a Notice of Exemption to the CFTC.

Exemptions for Underwriting and Broker-Dealer Activity

The Proposed Rules introduce an additional exemption from aggregation where an ownership interest is in an unsold allotment of securities. Specifically, the Proposed Rules provide that a person need not aggregate the positions or accounts of an owned entity if the ownership or equity interest is based on the ownership of securities constituting the whole or a 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.

Additionally, the Proposed Rules provide an exemption from aggregation to broker-dealers registered with the Securities and Exchange Commission, or with a foreign regulatory authority, with respect to the positions or accounts of an owned entity if such broker-dealer does not have greater than a 50% ownership or equity interest in the owned

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[65] The definition of "eligible entity" in the Proposed Rules is essentially unchanged from the existing definition under current Regulation 150.1(d) (other than some clarifying revisions). The term includes a commodity pool operator ("CPO"), a limited partner, limited member or shareholder in a commodity pool operated by an exempt CPO, a commodity trading advisor ("CTA"), a bank, insurance company and other entity which (1) authorizes an IAC independently to control all trading decisions with respect to the eligible entity's client positions and accounts which the IAC holds (directly or indirectly or on the eligible entity's behalf) but without the eligible entity's day-to-day direction and (2) maintains only such minimum control over the IAC as is consistent with its fiduciary responsibilities to the managed positions and accounts and necessary to fulfill its duty to supervise diligently the trading done on its behalf.

[66] The definition of "independent account controller" in the Proposed Rules is substantially similar to the existing definition under current Regulation 150.4(e), except that proposed definition allows managers of employee benefit plans (*i.e.*, persons that manage a commodity pool operated by a CPO exempt from registration under Regulation 4.5(a)(4)) to be treated as an IAC (so long as they comply with a notice requirement). In order to qualify as an IAC, a person must (1) trade independently of the relevant eligible entity and of any other IAC trading for the eligible entity, (2) have no knowledge of the trading decisions by any other IAC and (3) either be (a) registered as an FCM, CTA, introducing broker or an associated person of any such registrant or (b) a general partner, managing member or manager of a commodity pool operated by a CPO exempt from registration under Regulation 4.5(a)(4) or 4.13 (provided the general partner, managing member or manager provides a Notice of Exemption to the CFTC).

entity and the interest is based on the ownership of securities acquired in the normal course of business as a dealer (so long as the broker-dealer does not have knowledge of the owned entity's trading decisions).

A person relying on either of these exemptions need not file any notice with the CFTC.

Proposed Rules Maintain Other Existing Exemptions

The Proposed Rules maintain the existing aggregation exemption in current Part 150 for limited partners, shareholders and other similar types of pool participants with an ownership or equity interest of 10% or greater in a pooled account or positions, subject to certain conditions. As is the case under the existing exemption, the proposed exemption is available to a pool participant that is a principal or affiliate of the pool's operator if certain conditions are met to ensure that the pool participant is not involved in the pool's trading decisions and does not exert more than a minimum level of control over the operator.

The Proposed Rules also maintain the existing conditional exemptions from aggregation in current Part 150 for positions held by an FCM 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 of its officers, partners, employees or affiliates.

Persons relying on either exemption must file a Notice of Exemption with CFTC.

Notice of Exemption, Majority Ownership Exemption Request and Other CFTC Filings

Notice of Exemption: The Proposed Rules require a person[67] seeking certain specified aggregation exemptions to file a Notice of Exemption with the CFTC, which will be effective upon submission. The specified exemptions are those for: (1) a pool participant that is a principal or affiliate of the pool's operator and has an ownership or equity interest of 10% or greater in a pooled account or positions; (2) a person with an ownership or equity interest in an owned entity of 10% or greater but not more than 50%; (3) a person claiming the exemption for interests in an owned entity of greater than 50% where, subsequent to a CFTC finding that the conditions of that exemption are met, there is a material change to the information provided to the CFTC in the original filing; (4) accounts held by FCMs; (5) accounts carried by an IAC; and (6) information sharing restrictions.

[67] Under the Proposed Rules, where an owned entity has filed a Notice of Exemption, a person with an ownership or equity interest of 10% or greater in the owned entity need not file a separate notice identifying the same positions and accounts previously identified in the owned entity's filing so long as (1) such person complies with the conditions of the applicable exemption (other than filing requirements) and (2) such person does not otherwise control trading of the accounts or positions in the owned entity's notice.

A Notice of Exemption must include:[68] (1) a description of the relevant circumstances warranting disaggregation and (2) a statement of a senior officer of the entity certifying that the conditions set forth in the applicable exemption provision have been met. The Proposed Rules contemplate that the notice would be filed before the aggregation exemption is needed. However, where a prior filing is impractical (such as where a person lacks information regarding a newly-acquired subsidiary's activities), the notice should be filed as promptly as practicable, but would not be effective retroactively. In the event of a material change to the information provided in this notice, the Proposed Rules require the reporting entity to promptly file an updated or amended notice detailing the change.

Majority Ownership Exemption Request: As noted above, a person relying on the Majority Ownership Exemption must file a Majority Ownership Exemption Request with the CFTC when first requesting such disaggregation relief. The request must include (1) a description of the relevant circumstances warranting disaggregation; (2) a statement of a senior officer of the owner certifying that the conditions have been met; (3) a demonstration that procedures are in place that are reasonably effective to prevent coordinated trading decisions by the owner, any entity the owner must aggregate and the owned entity; and (4) the Bona Fide Hedging Certification. Additionally, under the Proposed Rules, if there is a material change to the information provided to the CFTC in the owner's request (after the CFTC has approved the request), the owner must file a Notice of Exemption with the CFTC.

Additional Information Upon CFTC Request: The Proposed Rules provide that, upon call by the CFTC, any person claiming any exemption from aggregation under Regulation 150.4 must provide such information as requested by the CFTC demonstrating that the person meets the requirements of the exemption. Upon notice and opportunity for the affected person to respond, the CFTC could amend, suspend, terminate or otherwise modify a person's exemption.

Form and Manner of Reports and Filings: The Proposed Rules provide that, unless otherwise instructed by the CFTC or its designees, any person submitting reports under Regulation 150.4 must submit the corresponding required filings and any other required information to the CFTC using the format, coding structure and electronic data transmission procedures approved in writing by the CFTC. Additionally, when the reporting entity discovers errors or omissions in past reports, the Proposed Rules require

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[68] The CFTC proposes that entities could consolidate these notice filings in an efficient manner by, for instance, discussing more than one owned entity in a single filing (so long as the scope of the filing is clear).

that the entity notify the CFTC and file corrected information as instructed by the CFTC or its designee.

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Please feel free to contact us with any questions.

November 22, 2013

APPENDIX A

CFTC RESPONSE TO WORKING GROUP PETITION

Below is a summary of each of the Working Group's requests and the CFTC's proposed action:

- Request One. Unfixed Price Transactions Involving a Non-Referenced Contract: In a hedge of an unfixed price purchase and unfixed price sale of a physical commodity in which one leg is a Referenced Contract and the other is not, the Working Group requested that the former be treated as a bona fide hedge. This is permitted under the Proposed Rules (as a cross-commodity hedge or a hedge of an offsetting unfixed-price cash commodity sale and purchase).
- Request Two. Offsetting Unfixed Price Transactions Hedged with Derivatives in Same Calendar Month: The Working Group requested that hedges of an unfixed price purchase and an unfixed price sale of a physical commodity in which the separate legs of the hedge are in the same calendar month, but which do not offset each other (since they are in different contracts or for any reason), be treated as bona fide hedging positions. This is permitted under the Proposed Rules (under the same categories as Request One).
- Request Three. Unpriced Physical Purchase or Sale Commitments: The Working Group requested that Referenced Contracts used to lock in a price differential where one leg of the underlying transaction is an unpriced commitment to buy or sell a physical energy commodity, and the offsetting sale or purchase has not been completed, be treated as a bona fide hedge. The Proposed Rules do not permit this. The CFTC notes that this differs from the positions described in Requests One and Two in that both sides of the cash transactions have not been contracted and, as a result, the trader has not established a definite exposure to a value change. Since merchandizing intentions are alone not sufficient to recognize a price risk, the trader has not established a definite exposure to a value change.[69]
- Request Four. Binding, Irrevocable Bids or Offers: The Working Group requested that Referenced Contracts used to hedge exposure to market volatility associated with binding and irrevocable fixed-price bids or offers be treated as bona fide hedging

[69] While the CFTC acknowledges that there can be a gradation of probabilities that an anticipated transaction will occur, it notes that Request Three provides no context in which to evaluate the nature or probability of an anticipated merchandising transaction. The CFTC indicates that it requires more details regarding the transaction to evaluate any price risk and that such details could be provided in a request for interpretative guidance or exemptive relief.

positions. The Proposed Rules do not permit this since the cash transaction (*i.e.*, a binding bid or offer) is tentative, in that the price risk is contingent on whether the bid or offer is accepted.[70]

- Request Five. Timing of Hedging Physical Transactions: The Working Group requested that Referenced Contracts used to hedge a physical transaction that is subject to ongoing, good-faith negotiations, and that the hedger reasonably expects to conclude, be treated as bona fide hedges. As with Request Four, since the cash transaction is tentative (in that the price risk is subject to ongoing negotiation), it fails the "change in value" requirement.
- Request Six. Local Natural Gas Utility Hedging of Customer Requirements: The Working Group requested that long positions in Referenced Contracts purchased by a state-regulated natural gas utility to hedge the price of natural gas that it expects to purchase and supply to its retail customers be treated as bona fide hedging transactions or positions. The bona fide hedging definition under the Proposed Rules would grant this request by including as an enumerated bona fide hedging position a long position in a commodity derivative contract that does not exceed in quantity unfilled anticipated requirements of the same cash commodity for resale by a utility that is required or encouraged to hedge by its PUC on behalf of its customers' anticipated use.
- Request Seven. Use of Physical-Delivery Referenced Contracts to Hedge Physical Transactions Using Calendar Month Average Pricing: The Working Group requested that firms engaged in calendar month average ("CMA") pricing transactions involving physical-delivery Referenced Contracts be permitted to hold such positions through the spot month as bona fide hedges. The Position Limits Release addresses several scenarios raised by the Working Group relating to this request, as follows:
  - Scenario One: Refinery hedging unfilled anticipatory requirements for crude oil on a CMA basis and cross-hedging the sale of anticipated processed distillate products. On each trading day over a one-month period prior to expiration of the nearby NYMEX light sweet crude oil ("WTI") futures contract, a refinery purchases futures contracts in the nearby contract month and sells an equivalent amount of futures in the next two deferred contract months in that same contract. The resulting positions are calendar month spreads in WTI futures, acquired at an

70 The Proposed Rules also do not adopt the Working Group's suggestion that the relief be conditioned on a good-faith showing and immediate reclassification of the portion of the position not awarded against the bid or offer since this would not protect against the prospect that multiple participants might make good-faith bids or offers on a single cash market solicitation and enter into derivatives to cover their potential exposure, while also holding positions on the same side of the market at the limit. The CFTC notes that if this request were granted, such persons could, in the aggregate, hold derivatives in an amount far larger than the amount to be awarded under the solicitation, resulting in undue volatility when the winning bid is accepted and the losers all reduce their positions below the limit.

average price over the one-month period. After establishing the spreads, the refinery engages in exchange of futures for physical commodity ("EFP") transactions, obtaining a short nearby WTI futures position in exchange for entering into cash market contracts to purchase crude oil at a fixed price over the next calendar month. These short positions offset the nearby long positions of the calendar month spread. Finally, as the refinery takes deliveries of crude oil over the next calendar month on the cash market contracts (or under the physical delivery provisions of the futures contracts), it processes the oil, sells the distillates on the spot market and buys back the short WTI futures positions in the next two contract months.

The CFTC states that the long positions in this scenario are hedges of unfilled anticipated requirements and are therefore bona fide hedging positions. Additionally, the CFTC views the short positions as an integral component of the calendar spreads (since the long positions alone may not be economically appropriate to the reduction of commercial risk). During the period in which the refinery holds a calendar spread position, the short positions (when considered as a whole with the long positions) would qualify as bona fide hedging positions (specifically, hedges of unsold anticipated production and cross-commodity hedges), so long as the long positions fix the input price and the short positions fix a significant portion of the price of the expected output of distillates that are not yet sold at a fixed price. During the subsequent period when the refinery holds only a short futures position and either contracts for the purchase of crude oil at a fixed price or holds oil in inventory (by taking delivery on the futures), it initially holds a bona fide hedge of inventory or a cash commodity purchase contract, which converts to a bona fide cross-commodity hedge when the oil is processed.

- Scenario Two: Merchant short hedge of CMA price purchase of crude oil from producer and long position to cover anticipated resale of crude oil at CMA. A producer sells oil at the price at which it was valued (basis WTI futures) on each day it was extracted. The buyer is an aggregator that pays each producer for crude oil on a CMA basis for the prior month's production, seeking to ensure the CMA selling price of the purchased oil. The aggregator sells the nearby WTI futures each trading day over a one-month period and buys an equivalent quantity of WTI futures in the subsequent two deferred WTI contract months. The aggregator then intends, in an EFP transaction, to exchange long futures in the nearby contract month for the sales contract to be delivered ratably over the delivery period of the nearby contract month (*i.e.*, the aggregator would sell the long futures each day as

oil is delivered ratably during the month, effectively realizing the price of the prompt barrel on that trading day).

The CFTC agrees that, once the aggregator has committed at a fixed price to take delivery of the oil, it holds a bona fide hedge of a cash commodity purchase contract (since the aggregator has built a short futures position by selling futures daily as the purchase commitment was being fixed). This bona fide hedge continues even after the aggregator takes delivery of the oil. However, the CFTC does not recognize as a bona fide hedge the long futures position since the price risk of the purchase contract has already been offset using the short position.

- Request Eight. Holding a Hedge Using a Physical-Delivery Contract into the Spot Month. The CFTC proposes to permit firms using physical-delivery Referenced Contracts as bona fide hedging positions to hold these hedges into the spot month (as a hedge of unfilled anticipated requirements).
- Requests Nine. Holding a Cross-Commodity Hedge Using a Physical-Delivery Contract into the Spot Month: The CFTC will not permit firms using physical-delivery Referenced Contracts as a cross-commodity hedge to hold such hedges into the spot month, since a person holding a large physical-delivery futures position who has no intention to make or take delivery may cause a disruption during the delivery period.
- Request Ten. Holding a Cross-Commodity Hedge Using a Physical-Delivery Contract to Meet Unfilled Anticipated Requirements: Based on the same reasoning described above with respect to Request Nine, the CFTC will not permit firms holding cross-commodity hedges involving physical-delivery Referenced Contracts to hold such hedges into the spot month in order to meet their unfilled anticipated requirements.