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Title: Preparing for Position Limits for Derivatives

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On July 21, 2010 President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (“the Act”) into law.¹ Section 737 of the Act requires the Commodity Futures Trading Commission (“the Commission”) to establish position limits for certain derivatives based on physical commodities. Congress added this section in order to prevent excessive speculation and market manipulation by traders.² On January 26, 2011, the Commission issued notice of proposed rulemaking, *Position Limits for Derivatives*, to implement the requirements of Section 737.³

Corporations will need to be mindful in preparing to comply with the position limit regulations. Corporations will need to evaluate what swaps qualify as “economically equivalent” to the referenced derivatives. Additionally, corporations will need to establish a recordkeeping system to keep track of their referenced derivatives aggregated through entities that the corporation owns 10% or more of. Finally, for corporations that may come close to the position limits, they will need to assess if any of their derivatives may qualify as “bona fide hedges.” This article will provide a brief overview of the pertinent parts of the proposed rulemaking.

Position Limits

The Commission proposed position limits to be imposed on futures and options contracts that are based on 28 specific physical commodities.⁴ In addition to position limits on the referenced futures and options contracts, Section 737 of the Act requires the Commission to establish position limits on: (1) swaps traded on a designated contract market (“DCM”) or swap execution facility (“SEF”); (2) swaps that are economically equivalent to DCM futures and options contracts with position limits; and (3) swaps that perform a “significant price discovery function” with respect to a registered entity.⁵ While the proposed regulation articulates the 28 physical commodities futures and options contracts that are

subject to the position limits,⁶ traders will need to review their swap portfolios in order to determine whether their swaps qualify as “economically equivalent.”

The Commission is proposing to establish position limits in two phases - the first phase will establish spot-month position limits and the second phase will establish non-spot-month position limits.⁷

Spot-Month Position Limits

In the first phase of implementation, the Commission will establish “spot-month” position limits. “Spot-month” refers to the trading period immediately preceding the delivery period.⁸ The regulation proposes that a trader may not hold or control positions in “referenced contracts”⁹ in the same commodity when such positions are in excess of 25% of estimated spot-month deliverable supply of referenced contracts in the commodity.¹⁰ The DCMs shall provide the Commission with their estimate of deliverable supply for each referenced contract.¹¹ The Commission will rely on the estimates provided by the DCMs to establish their estimate of deliverable supply.¹²

Traders should note that proposed regulation § 151.4 applies spot-month position limits separately for physically-delivered contracts¹³ and cash-settled contracts.¹⁴ Therefore, if the spot-month position limit for a commodity is 10,000 contracts, then a trader may hold up to 10,000 physically-delivered contracts and 10,000 cash-settled contracts.¹⁵

Non-Spot-Month Position Limits

Non-spot-month position limits will be imposed in the second implementation period.¹⁶ There are two classes of contracts in connection with the non-spot-month position limit: (1) futures and options contracts executed pursuant to the rules of a DCM, and (2) swaps.¹⁷ Additionally, the proposed regulation also imposes position limits on the aggregate of both contract classes that are based on the same underlying physical commodity.¹⁸

The two contract classes, as well as the aggregate, have both a single-month position limit and an all-months-combined position limit.¹⁹ The position limits are based on the overall open interest for a particular referenced contract in the same commodity, in the aggregate or on a contract class basis.²⁰ The non-spot-month position limit for the aggregate single-month and aggregate all-months-combined is 10% of the first 25,000 contracts of open interest, and 2.5% of the open interest in excess of 25,000 contracts.²¹ Traders may combine their long and short positions to result in a net position.²²

For the contract classes, the single-month and all-months-combined position limits are set at a level equal to the all-months-combined aggregate position limit.²³ For both the aggregate and contract classes, the Commission has proposed that the single-month limits are equal to the all-months-combined limit levels.²⁴

Aggregation of Positions

Proposed regulation § 151.7 establishes account aggregation standards for positions in the 28 physical commodity derivatives.²⁵ The proposed general rule is that a trader must aggregate positions in all accounts in which the trader has a 10 percent or greater ownership or equity interest.²⁶ However, aggregation is not required when a trader owns a non-financial entity that is independently controlled and managed.²⁷ Therefore, it is important that corporations perform an entity-ownership analysis to determine what entities it must aggregate for position limit purposes.

Additionally, if two or more traders are acting pursuant to an express or implied agreement, then the positions held by the traders will be treated as if the positions were held by one trader.²⁸ Finally, it should be noted that the proposed regulation establishes new aggregation rules for passive pool participants that are different from the current rules.²⁹

Bona Fide Hedge

Section 737 of the Act amended Section 4a(a) of the Commodity Exchange Act (“CEA”) to define a “bona fide hedging transaction” for purposes of position limits.³⁰ Under the proposed regulation, any

derivative that meets the “bona fide hedge” requirement will not violate the position limits.³¹

Additionally, the proposed regulations allow for swaps that are not “bona fide hedging transactions” to be considered as such when the swap qualifies as a “bona fide hedging transaction” for the swap counterparty.³² Therefore, it is necessary for traders who intend to qualify for “bona fide hedging transactions” to maintain complete records of their derivative positions and the individual counterparties in order to give this information to the Commission upon request.³³

Other Matters – Foreign Boards of Trade & Pre-Existing Positions

Derivatives of the 28 referenced physical commodities that are executed on a foreign board of trade are included in the aggregate position limit.³⁴ Thus, corporations must review their global derivatives portfolio, as opposed to just derivatives executed on a board of trade in the United States. The position limits may be exceeded to the extent that positions were entered into in good faith prior to the effective date of any regulation or rule that specifies a position limit.³⁵

Conclusion

Notice of proposed rulemaking, *Position Limits for Derivatives*, implements the position limit requirements that were established in Section 737 of the Dodd-Frank Act. The proposed regulation establishes many rules that will affect corporations that invest in derivatives based on the 28 referenced physical commodities. Therefore, it is imperative that corporations implement reporting systems and review processes in order to prepare for the implementation of this proposed regulation.

¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

² Section 737 of the Act.

³ Position Limits for Derivatives, 76 Fed. Reg. 4,752 (Jan. 26, 2011).

⁴ Position Limits for Derivatives, 76 Fed. Reg. at 4,768-69 (to be codified at 17 C.F.R. 151.2). The 28 referenced futures contracts cover 19 agricultural commodities, 5 metals, and 4 energy commodities. *Id.*

⁵ Proposed regulation § 151.1 defines “swap contract class” as “referenced contracts that are based on the same commodity and are swaps.”

⁶ Position Limits for Derivatives, 76 Fed. Reg. at 4,768-69 (to be codified at 17 C.F.R. 151.2).

⁷ Position Limits for Derivatives, 76 Fed. Reg. at 4,752-53.

⁸ Position Limits for Derivatives, 76 Fed. Reg. at 4,757. Thus, the length of the period will depend on the commodity that the referenced contract is based on.

⁹ The term “referenced contracts” refers to futures contracts, options contracts, and swaps that are based on the 28 “referenced” physical commodities that are subject to position limits.

¹⁰ Position Limits for Derivatives, 76 Fed. Reg. at 4,770 (to be codified at 17 C.F.R. 151.4).

¹¹ Position Limits for Derivatives, 76 Fed. Reg. at 4,770 (to be codified at 17 C.F.R. 151.4(c)(2)).

¹² Position Limits for Derivatives, 76 Fed. Reg. at 4,770 (to be codified at 17 C.F.R. 151.4(c)(4)).

¹³ “Physically-delivered contracts” are futures contracts or derivatives that call “for the physical delivery of a commodity to satisfy the contract.” Commodity Futures Trading Commission Glossary.

¹⁴ “Cash-settled contracts” are contracts that are settled whereby “the seller (or short) pays the buyer (or long) the cash value of the underlying commodity or a cash amount based on the level of an index or price according to a procedure specified in the contract.” Commodity Futures Trading Commission Glossary.

¹⁵ Position Limits for Derivatives, 76 Fed. Reg. at 4,757.

¹⁶ Position Limits for Derivatives, 76 Fed. Reg. at 4,758.

¹⁷ Position Limits for Derivatives, 76 Fed. Reg. at 4,758-59.

¹⁸ Position Limits for Derivatives, 76 Fed. Reg. at 4,759 (to be codified at 17 C.F.R. 151.4(d)).

¹⁹ Position Limits for Derivatives, 76 Fed. Reg. at 4,758-59. Thus, there are six possible non-spot-month position limits for which the open interest will need to be calculated: (1) futures and options contracts single-month; (2) futures and options contracts all-months-combined; (3) swaps single-month; (4) swaps all-months-combined; (5) aggregate single-month; and (6) aggregate all-months-combined.

²⁰ Position Limits for Derivatives, 76 Fed. Reg. at 4,758.

²¹ Position Limits for Derivatives, 76 Fed. Reg. at 4,770 (to be codified at 17 C.F.R. 151.4(d)(1)).

²² Position Limits for Derivatives, 76 Fed. Reg. at 4,770 (to be codified at 17 C.F.R. 151.4(f)).

²³ Position Limits for Derivatives, 76 Fed. Reg. at 4,770 (to be codified at 17 C.F.R. 151.4(d)(2)).

²⁴ Position Limits for Derivatives, 76 Fed. Reg. at 4,759.

²⁵ Position Limits for Derivatives, 76 Fed. Reg. at 4,762.

²⁶ Position Limits for Derivatives, 76 Fed. Reg. at 4,774 (to be codified at 17 C.F.R. 151.7).

²⁷ Position Limits for Derivatives, 76 Fed. Reg. at 4,774 (to be codified at 17 C.F.R. 151.7(f)).

²⁸ Position Limits for Derivatives, 76 Fed. Reg. at 4,774 (to be codified at 17 C.F.R. 151.7).

²⁹ Position Limits for Derivatives, 76 Fed. Reg. at 4,774 (to be codified at 17 C.F.R. 151.7(c)).

³⁰ Section 737 of the Act (amending 7 U.S.C. 6a(c)(2)).

³¹ Position Limits for Derivatives, 76 Fed. Reg. at 4,770 (to be codified at 17 C.F.R. 151.5(a)). Note that the Commission is proposing that the “bona fide hedging transaction” exemption applies to all referenced contracts, including swaps. Position Limits for Derivatives, 76 Fed. Reg. at 4,760.

³² Position Limits for Derivatives, 76 Fed. Reg. at 4,773 (to be codified at 17 C.F.R. 151.5(g)).

³³ Position Limits for Derivatives, 76 Fed. Reg. at 4,772 (to be codified at 17 C.F.R. 151.5(e)).

³⁴ Position Limits for Derivatives, 76 Fed. Reg. at 4,774 (to be codified at 17 C.F.R. 151.8).

³⁵ Position Limits for Derivatives, 76 Fed. Reg. at 4,775 (to be codified at 17 C.F.R. 151.9).