Client Alert

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CFTC Approves Supplemental Proposal on Position Limits to Permit Exchanges to Recognize Non-Enumerated Bona Fide Hedges

By Julian E. Hammar

On May 26, 2016, the Commodity Futures Trading Commission ("CFTC") approved a proposed supplement ("Supplemental Proposal") to its December 2013 proposal to establish position limits on 28 core physical commodity contracts and economically equivalent futures, options, and swaps ("2013 Position Limits Proposal"). The Supplemental Proposal would provide for a new process for exchanges to recognize certain positions in commodity derivatives contracts as "non-enumerated" bona fide hedges (not already enumerated in CFTC regulations) or enumerated anticipatory bona fide hedges, as well as to exempt from CFTC position limits certain spread positions, in each case subject to CFTC review. In addition, the Supplemental Proposal would amend the definition of the term "bona fide hedging position" for physical commodities and certain other definitions contained in the 2013 Position Limits Proposal and would also delay the requirement that designated contract markets ("DCMs") and swap execution facilities ("SEFs") establish and monitor position limits on swaps where the DCM or SEF lacks access to sufficient swap position information. The Supplemental Proposal, which was published in the Federal Register on June 13, 2016,[1] will be open for public comment until **July 13, 2016**. The Supplemental Proposal is available here.

BACKGROUND

Under the 2013 Position Limits Proposal,[2] the CFTC limited the definition of the term bona fide hedging position to an enumerated list of hedging strategies. If a hedging strategy was not on the list, it did not qualify as a bona fide hedge, and, in order to exceed an applicable position limit, a market participant would either have to request an interpretive letter from CFTC staff pursuant to CFTC Regulation 140.99[3] that would recognize the proposed hedging strategy as a bona fide hedge or seek exemptive relief from the CFTC under Section 4a(a)(7) of the Commodity Exchange Act ("CEA").[4] A number of commenters expressed the view that the 2013 Position Limits Proposal's narrow definition of enumerated hedges would exclude legitimate hedging transactions commonly used by commercial enterprises. Moreover, the processes for obtaining relief, which could only be obtained from the CFTC or its staff, did not provide for deadlines or standards, which raised concerns about whether a response could be obtained in a commercially reasonable time. At a meeting of the CFTC's Energy and Environmental

[1] See Position Limits for Derivatives: Certain Exemptions and Guidance, 81 Fed. Reg. 38,457 (June 13, 2016).

[2] See Position Limits for Derivatives, 78 Fed. Reg. 75,679 (Dec. 12, 2013). For further background information on the 2013 Position Limits Proposal, please see our client alert here.

[3] 17 CFR 140.99.

[4] 7 U.S.C. 6a(a)(7).

Markets Advisory Committee in July 2015, the CME Group and ICE Futures U.S. presented a proposal to allow the exchanges to issue hedge exemptions, as they currently do under CFTC rules, subject to CFTC oversight.

SUPPLEMENTAL PROPOSAL

In response to the concerns mentioned above, the CFTC issued the Supplemental Proposal, which provides for exchange recognition of bona fide hedges and exemption of spread positions, makes amendments to the definition of the term bona fide hedging position, and delays exchange-set position limits for swaps.

Exchange Recognition of Bona Fide Hedges and Exemption of Spread Positions

The Supplemental Proposal includes three proposed regulations that would permit exchanges to submit to the CFTC rules pursuant to which the exchange could, respectively: (i) recognize non-enumerated bona fide hedging positions ("NEBFHs"),[5] (ii) grant exemptions to position limits for certain spread positions,[6] and (iii) recognize enumerated anticipatory bona fide hedging positions.[7] Market participants would be required to apply for recognition as bona fide hedges or spread exemptions prior to exceeding any applicable position limit, which would include both exchange-set and CFTC-set limits. Any recognition of a bona fide hedge or grant of a spread exemption by the exchange would apply for one year, after which a market participant would be required to reapply.

When determining whether to recognize positions as NEBFHs, an exchange would be required to apply the standards in the CFTC's general definition of bona fide hedging, which incorporates the standards in Section 4a(c)(2) of the CEA.[8] Spreads that the exchanges may approve under the process for granting spread exemptions include calendar spreads, quality differential spreads, processing spreads (such as energy "crack" or soybean "crush" spreads), and product or by-product differential spreads.[9] The enumerated anticipatory bona fide hedging positions that would be eligible for recognition, which were included in the 2013 Position Limits Proposal, are unfilled anticipated requirements, unsold anticipated production, anticipated royalties, anticipated service contract payments or receipts, and anticipatory cross-commodity hedges.[10]

The CFTC would review an exchange's actions under these processes under its rule enforcement review program. It also would retain the ability to review an exchange's determination to recognize any non-enumerated hedge position as bona fide (or an enumerated anticipatory bona fide hedging position) or grant of a spread exemption, either before or after an exchange makes a determination or grants an exemption. If after such a review the CFTC determines to reverse a determination or revoke an exemption granted by the exchange, the

[5] See Proposed Reg. 150.9.

[6] See Proposed Reg. 150.10.

[7] See Proposed Reg. 150.11.

[8] 7 U.S.C. 6a(c)(2). See Proposed Reg. 150.9(a)(1).

[9] See Proposed Reg. 150.10(b)(2).

[10] See Proposed Reg. 150.11(a)(1).

recipient of the determination or exemption would be afforded a commercially reasonable amount of time to reduce its position below the applicable position limit.[11]

In order for an exchange to process applications for recognizing bona fide hedges or granting spread exemptions under the Supplemental Proposal, it would have to meet certain requirements that are generally similar for the three processes outlined above. For example, an exchange may process NEBFH applications only if (i) the commodity derivative is a "referenced contract," (ii) the exchange lists the commodity derivative contract for trading, (iii) the commodity derivative contract is actively traded on the exchange, (iv) the exchange has established position limits for the commodity derivative contract, and (v) the exchange has at least one year of experience and expertise administering position limits for the commodity derivative contract.[12] Exchanges would not be permitted to recognize an NEBFH or grant a spread exemption involving a commodity index contract and one or more futures contracts subject to position limits (i.e., risk management exemptions).[13]

If an exchange recognizes an NEBFH or grants a spread exemption, the Supplemental Proposal would require that the exchange post a summary of the general hedging strategy or spread position to its website (without revealing the identity of the hedger) that would be subject to CFTC review.[14] With regard to NEBFHs only, an exchange would be permitted to establish separate application processes under its rules for persons to demonstrate why a position constitutes an NEBFH under novel facts and circumstances and under facts and circumstances substantially similar to a position for which a summary has been published.[15] In the latter case, the process may be less expansive.[16]

Each of the processes includes detailed application requirements for market participants, including any additional information necessary for the exchange to process the application.[17] In addition, an exchange would be required to have rules requiring that applicants file a report (that must be kept updated) with the exchange when such applicants own or control a position that has been recognized as a bona fide hedge (or granted a spread exemption) and for such applicants to report the offsetting cash position (in the case of a spread exemption, applicants must report each component of the spread).[18]

[11] See Proposed Regs. 150.9(d), 150.10(d), and 150.11(d).

[12] See Proposed Reg. 150.9(a)(1). Similarly, to process spread exemption applications, exchanges must list for trading at least one contract that is either a component of the spread or a referenced contract that is a component of the spread, and such contract must be actively traded and have been subject to the Exchange's position limits for at least one year. See Proposed Reg. 150.10(a)(1). The requirements for exchanges to recognize enumerated anticipatory bona fide hedges are similar to those for NEBFHs. See Proposed Reg. 150.11(a)(1).

[13] The CFTC explains that the enumerated anticipatory bona fide hedges would not implicate commodity index contracts. See 81 Fed. Reg. at 38,480 n.195.

[14] The web-posting requirement would not apply to enumerated anticipatory bona fide hedges.

[15] See Proposed Reg. 150.9(a)(2).

[16] See 81 Fed. Reg. at 38,471.

[17] See Proposed Regs. 150.9(a)(3), 150.10(a)(3), and 150.11(a)(2).

[18] See Proposed Regs. 150.9(a)(6), 150.10(a)(6), and 150.11(a)(5).

Under each of the processes, exchanges would have to keep certain records, including all information and documents submitted by an applicant, records of oral and written communications between the exchange and the applicant in connection with an application, and all information in connection with the exchange's analysis of an action on such application.[19] The exchanges would also be required to submit reports to the CFTC that include information about NEBFHs (or enumerated anticipatory bona fide hedges) recognized and spread exemptions granted.[20]

Amendments to the Definition of Bona Fide Hedging Position

In addition to the processes in the proposed regulations outlined above, the Supplemental Proposal amends the definition of the term bona fide hedging position, which the exchanges must follow in recognizing non-enumerated bona fide hedges. The amended definition essentially tracks the definition of bona fide hedging in Section 4a(c)(2) of the CEA, which provides that a "bona fide hedging transaction or position" means a transaction or position that:

- represents 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;
- is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and
- arises from the potential change in the value of—
    - assets that a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising;
    - liabilities that a person owns or anticipates incurring; or
    - services that a person provides, purchases, or anticipates providing or purchasing; or
- reduces risks attendant to a position resulting from a swap that was executed opposite a counterparty for which the transaction would qualify as a bona fide hedging transaction or that reduced the risk attendant to a position resulting from a transaction that qualifies as a bona fide hedging transaction.[21]

The 2013 Position Limits Proposal had defined the term bona fide hedging position to include two requirements in addition to those included in the statutory definition: the "orderly trading requirement" and the "incidental test," which were contained in the CFTC's regulatory definition of bona fide hedging. Under the orderly trading requirement, a bona fide hedging position would have to be established and liquidated in an orderly manner in accordance with sound commercial practices. The incidental test would have required that the risks offset by a commodity derivatives position must be incidental to the position holder's commercial operations.

[19] See Proposed Regs. 150.9(b) (NEBFHs), 150.10(b) (spread exemptions), and 150.11(d) (enumerated anticipatory bona fide hedges).

[20] See Proposed Regs. 150.9(c) (NEBFHs), 150.10(c)(spread exemptions), and 150.11(c)(enumerated anticipatory bon fide hedges).

[21] See 7 U.S.C. 6a(c)(2).

The Supplemental Proposal would eliminate the orderly trading requirement and the incidental test from the definition of the term bona fide hedging position. With regard to the orderly trading requirement, the CFTC states that it is not aware of a denial of a bona fide hedge due to a lack of orderly trading on an exchange and notes that disruptive trading activity by a commercial entity engaged in establishing or liquidating a hedging position would generally appear to be contrary to its economic interests. Moreover, the CFTC notes that market participants would remain subject to other provisions within the CEA in any event, such as restrictions on disruptive trading and manipulation, and thus the orderly trading requirement is unnecessary.[22] With respect to the incidental test, the CFTC states that it interprets the incidental test similarly to the requirements of the statutory requirement that bona fide hedges be "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise," rendering the incidental test unnecessary. The CFTC confirmed that it continues to read the statutory "economically appropriate" test to refer to price risk only (consistent with its interpretation of the "incidental test') and does not include other risks, such as execution, logistics, or credit risk.[23]

Delay for Exchange-Set Position Limits for Swaps

The Supplemental Proposal also proposes to temporarily delay the requirement for an exchange to establish position limits on swaps where the exchange lacks access to sufficient swap position information. The CFTC states in the preamble that it believes that most exchanges do not have access to sufficient swap position information at this time to effectively monitor swap position limits. The Supplemental Proposal includes proposed guidance that would provide that DCMs or SEFs need not demonstrate compliance with the position limit core principles applicable to swaps until they have access to sufficient swap position information, after which the guidance would no longer be applicable.[24] While providing for this delay in exchange-set limits, the Supplemental Proposal notes that federal position limits would apply to swaps that are economically equivalent to referenced futures contracts subject to federal limits.[25]

CONCLUSION

The Supplemental Proposal likely will be welcomed by many market participants. It should provide greater flexibility than the 2013 Position Limits Proposal by allowing the exchanges to recognize bona fide hedges and grant spread exemptions, rather than the CFTC processing the applications itself, which, given the CFTC's chronic lack or resources could create delays and inefficiencies. It also would draw upon the exchanges' extensive expertise in administering position limits, which they have done under the current position limits framework for many years, and their understanding of hedging activity. For those in favor of a robust position

[22] See generally 81 Fed. Reg. at 38,463-64.

[23] See generally 81 Fed. Reg. at 38,463. In addition to amending the term bona fide hedging position, the Supplemental Proposal would also amend the definition of the terms futures equivalent, intermarket spread position and intramarket spread position contained in the 2013 Position Limits Proposal. The amendments make certain clarifications regarding the term futures equivalent and expand the definitions of the terms intermarket spread position and intramarket spread position. See generally 81 Fed. Reg. at 38,482-83.

[24] See Proposed Guidance in Appendix B to Part 37, Core Principle 6 (applicable to SEFs) and Appendix B to Part 38, Core Principle 5 (applicable to DCMs). The guidance provides that an exchange would have access to sufficient swap position information if, for example: (i) it has access to daily information about its market participants' open swap positions or (ii) it knows that its market participants regularly engage in large volumes of speculative trading activity on the exchange that would cause reasonable surveillance personnel to inquire further. Id.

[25] See 81 Fed. Reg. at 38,462.

limits regime, the Supplemental Proposal provides for strong CFTC oversight of the exchanges in recognizing bona fide hedges and granting hedge exemptions, both through rule enforcement reviews of the exchanges and review of individual applications in appropriate circumstances. However, market participants may not favor the Supplemental Proposal's prohibition on risk management exemptions, which exchanges would not be permitted to grant.

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