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VanNess Feldman

CFTC Proposes Position Limits and Aggregation Rules for Energy and Other Commodity Derivatives

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On November 5, 2013, the Commodity Futures Trading Commission (CFTC) issued two notices of proposed rulemaking (NOPR) that collectively propose a new position limits regime for CFTC-regulated derivatives of energy, metals, and agricultural commodities. This is the CFTC's second attempt to set position limits after an appellate court vacated the CFTC's first rulemaking on the subject. The Position Limits NOPR sets limits on positions in 28 "core" commodity futures contracts and economically equivalent futures, options, and swaps (collectively "referenced contracts"), subject to certain exemptions, including for bona fide hedging positions. The related Aggregation NOPR reproposes aggregation standards for determining which positions an entity must aggregate when determining compliance with CFTC position limits. Energy companies managing their risk with derivatives, including trade options, will need to ensure compliance with the CFTC's position limits, aggregation standards, and exemptions when they are finalized. The CFTC indicated that the new position limits regime will become effective 60 days after publication of a final rule in the *Federal Register*.

BACKGROUND

Before enactment of Section 737 of the Dodd-Frank Act, Section 4a of the Commodity Exchange Act (CEA) only authorized the CFTC to set position limits for futures and options traded on commodities markets. Section 737 of the Dodd-Frank Act expanded the CFTC's authority to include position limits for economically equivalent swaps. The CFTC has interpreted Section 737 as requiring it to set position limits for futures, options, and economically equivalent swaps involving energy, metals, and agricultural commodities. In 2011, the CFTC proposed and finalized such position limits for 28 commodity futures contracts, including New York Mercantile Exchange (NYMEX) Henry Hub Natural Gas (NG), Light Sweet Crude Oil (CL), RBOB Gasoline (RB), and NY Harbor ULSD (HO) (2011 Position Limits Rule). In May 2012, the CFTC proposed aggregation standards for these 28 contracts as well. Then, in September 2012, the U.S. District Court for the District of Columbia vacated the 2011 Position Limits Rule in *ISDA v. CFTC*, 887 F. Supp. 2d 259 (D.D.C. 2012), finding that the CFTC had misinterpreted the CEA as unambiguously mandating the CFTC to impose the position limits without a prerequisite finding that such limits are necessary.

THE PROPOSED RULES

Key aspects of the Position Limits and Aggregation NOPRs are as follows:

New Position Limits. The CFTC reproposed position limits for referenced contracts relating to each of the 28 core commodity futures contracts. The CFTC also noted the possibility of position limits on other commodities, including electricity contracts, in subsequent rulemakings. The 28 identified core contracts include four energy contracts— NYMEX Henry Hub Natural Gas (NG); Light Sweet Crude Oil (CL); RBOB Gasoline (RB); and NY Harbor ULSD (HO). The definition of "referenced contract" does not include locational

basis contracts or commodity index contracts.

The Position Limits NOPR would cap, for each core contract, the positions a person can hold (absent an exemption) in:

- Physical delivery referenced contracts in the spot month;
- Cash-settled referenced contracts in the spot month;
- All referenced contracts in any single non-spot month; and
- All referenced contracts in all months combined.

The CFTC has proposed a variety of potential exemptions to these position limits. Market participants will have to evaluate their eligibility for these proposed exemptions. To the extent necessary, they would have to adjust their non-exempt positions to comply with the applicable position limits.

Revisions to the Bona Fide Hedging Position Exemption. Section 4a of the CEA directs the CFTC to exempt bona fide hedges from position limits. This is a key exemption for which energy companies may be eligible if they meet the applicable criteria. The Position Limits NOPR revises the CFTC's initially proposed definition of "bona fide hedging position."

A bona fide hedge is a position intended to offset price risks incidental to commercial operations. Generally, for a physical commodity hedge to qualify as a bona fide hedge, it must represent a substitute for a transaction or position in a physical marketing channel, be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, and arise from the potential change in value of the hedging party's current or anticipated assets or liabilities, or services that the hedging party provides or consumes. Further, a bona fide hedging position must generally fit within one of a list of hedges enumerated by the CFTC, including: (1) hedges of inventory and cash commodity purchase contracts; (2) hedges of cash commodity sales contracts; (3) hedges of unfilled anticipated supply or input requirements; (4) hedges by agents; (5) hedges of unsold anticipated production; (6) hedges of offsetting unfixed-price cash commodity sales and purchases; (7) hedges of anticipated royalties; (8) hedges of services; and (9) cross-commodity hedges.

Of note to energy utilities, the CFTC expanded the exemption for hedges of unfilled anticipated supply or input requirements to cover a utility's hedging of the unfilled anticipated requirements of its customers, where required or encouraged to do so by a state public utility commission. However, the CFTC declined to repropose an exemption for hedges of unfilled storage capacity; this hedge was included in the now-vacated 2011 Position Limits Rule. The Position Limits NOPR also notes that portfolio hedging can qualify as an enumerated hedge.

The CFTC also proposed that swaps that are trade options are subject to position limits and do not automatically qualify as bona fide hedges. Only trade options that independently qualify as a bona fide hedging position are eligible for the exemption.

Additionally, the CFTC proposed to exempt from position limits swaps entered into prior to the effective date of a final Position Limits Rule.

Aggregation NOPR. The CFTC also reproposed its "aggregation" policy, which prescribes which positions or accounts an entity must aggregate (*e.g.*, affiliate positions) for purposes of determining compliance with CFTC position limits. In the Aggregation NOPR, the CFTC proposed to maintain the CFTC's existing aggregation policy, which requires aggregation of all positions that an entity controls, or has a 10 percent or greater ownership interest in, for purposes of CFTC position limits. The CFTC proposed certain new exemptions to this policy, however. Among other exemptions, an entity may disaggregate the positions of a second entity if the first entity owns greater than 10 percent but less than 50 percent of the second entity, and it proves that the entities trade independently. An entity may also disaggregate the positions of a second entity even if the first entity owns greater than 50 percent of the second entity, so long as the entities trade independently and the second entity holds only bona fide hedging positions, or positions not greater than 20 percent of applicable position limits.

IMPLICATIONS

In the wake of the vacatur of the 2011 Position Limits Rule, the new Proposed Rules have been widely anticipated by the regulated community. While the CFTC did not depart significantly from the 2011 Position Limits Rule, it has made changes that appear to provide greater flexibility and regulatory certainty to regulated entities. For example, the CFTC's proposed revision of the bona fide hedging position definition provides needed clarity to energy utilities that regularly hedge in energy markets pursuant to a state-approved hedging strategy. However, the CFTC's proposed bona fide hedge position definition does not appear to cover certain types of energy industry hedges commonly considered to be non-speculative, including the hedging of contingent liabilities and certain more complex, multi-leg hedging strategies.

Moreover, although the CFTC has bolstered the legal rationale underlying the Proposed Rules in response to the D.C. District Court's ruling, some have speculated they could be challenged again in court after they are finalized. While the CFTC made a generalized finding that the proposed position limits are necessary to prohibit market manipulation, it declined to make such findings specific to each of the core commodities contracts, which could provide the basis for a legal challenge.

Comments on the Proposed Rule are due 60 days after publication in the *Federal Register*.

FOR MORE INFORMATION

Van Ness Feldman monitors and interprets CFTC developments, provides strategic counsel on company-specific issues, develops transaction audits and compliance plans, and advocates to CFTC and Congressional

policymakers. For additional information, please contact Lisa Epifani, David Yaffe, Kyle Danish, or any other member of our Natural Gas & Oil or Electric Practice Groups in Washington, DC at (202) 298-1800 or in Seattle, WA at (206) 623-9372.

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