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CFTC Adopts Position Limits Rule, Proposes to Extend Temporary Exemptive Relief From the Applicability of Certain Swap Provisions of the Dodd-Frank Act

On October 18, 2011, the Commodity Futures Trading Commission (“CFTC”) adopted a final rule regarding position limits for certain physical commodity derivatives (the “Final Rule”).¹ The Final Rule establishes position limits for 28 commodity futures contracts (“Core Referenced Futures Contracts”) as well as futures, options and swaps that are economically equivalent to those contracts (collectively, “Referenced Contracts”). These position limits will apply across different trading venues to each contract based on the same underlying commodity. At the same time, the CFTC also proposed to extend earlier temporary exemptive relief granted to swap market participants from various requirements under the Commodity Exchange Act (the “CEA”), as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) for an additional six months to July 16, 2012 to provide legal certainty and avoid undue disruption of the swap markets during transition to the new regulatory framework.²

Position Limits

Section 737 of the Dodd-Frank Act amends section 4a(a) of the CEA to require the CFTC to establish position limits for futures, options and economically equivalent swaps traded on a designated contract market (“DCM”) or swap execution facility (“SEF”), as well as for swaps that are not traded on a DCM or SEF but perform a “significant price discovery function” in order to prevent excessive speculation and manipulation of commodity prices.³ The Final Rule establishes spot-month and non-spot-month position limits for Core Referenced Futures Contracts and Referenced Contracts.

Covered Contracts

The Core Referenced Futures Contracts were selected by the CFTC due to high open interest and include the following contracts, by commodity category:

- (i) “Legacy” agricultural contracts: (1) CBOT Corn (C); (2) CBOT Oats (O); (3) CBOT Soybeans (S); (4) CBOT Soybean Meal (SM); (5) CBOT Soybean Oil (BO); (6) CBOT Wheat (W); (7) ICE Futures U.S. Cotton No.2 (CT); (8) KCBT Hard Winter Wheat (KW); and (9) MGEX Hard Red Spring Wheat (MWE);

¹ 17 C.F.R. Part 151 - Position Limits for Futures and Swaps, available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister101811c.pdf>.

² Notice of Proposed Amendment (the “Proposed Order”), 76 Fed. Reg. 65999 (October 25, 2011).

³ See Section 4a(a)(1) of the CEA, Section 737 of the Dodd-Frank Act.

(ii) Non-“legacy” agricultural contracts: (1) CME Class III Milk (DA); (2) CME Feeder Cattle (FC); (3) CME Lean Hog (LH); (4) CME Live Cattle (LC); (5) CBOT Rough Rice (RR); (6) ICE Futures U.S. Cocoa (CC); (7) ICE Futures U.S. Coffee C (KC); (8) ICE Futures U.S. FCOJ-A(OJ); (9) ICE Futures U.S. Sugar No. 11 (SB); and (10) ICE Futures U.S. Sugar No. 16 (SF);

(iii) Metal contracts: (1) COMEX Copper (HG); (2) COMEX Gold (GC); (3) COMEX Silver (SI), (4) NYMEX Palladium (PA); and (5) NYMEX Platinum (PL); and

(iv) Energy contracts: (1) NYMEX Henry Hub Natural Gas (NG); (2) NYMEX Light Sweet Crude Oil (CL); (3) NYMEX New York Harbor Gasoline Blendstock (RB); and (4) NYMEX New York Harbor Heating Oil (HO).⁴

Referenced Contracts include the applicable Core Referenced Futures Contract, as well as (i) "look-alike" contracts (i.e., those that settle off of the Core Referenced Futures Contract or that are based on the same commodity for the same delivery location as the Core Referenced Futures Contract); (ii) contracts with a reference price based on a combination of prices that includes at least one Referenced Contract price and one or more prices in the same or substantially the same commodity as that underlying the relevant Core Referenced Futures Contract; and (iii) intercommodity spreads⁵ with two components, one or both of which are Referenced Contracts.⁶

Calculation of Applicable Position Limits

Spot-Month Position Limits

Spot-month position limits apply to all trades of a market participant in any Referenced Contract in the period immediately before delivery obligations are incurred for physically-settled contracts or the period immediately before contracts are liquidated by a clearinghouse based on a reference price for cash-settled contracts and are specific to each Referenced Contract. Generally, spot-month position limits will be limited to 25% of the estimated spot-month deliverable supply of each respective Referenced Contract, applied separately to physically-settled and cash-settled contracts. Cash-settled NYMEX Henry Hub Natural Gas contracts⁷ will be limited to five times the spot-month position limit established for physically-settled contracts. The aggregate limit across physically-settled and cash-settled NYMEX Henry Hub Natural Gas contracts also will be set at five times the spot-month position limit for physically settled contracts.⁸

⁴ 17 C.F.R. Part 151.2.

⁵ Intercommodity spreads are arbitrage transactions aimed to benefit from changes in the price relationship of different (but usually associated) commodities. Intercommodity spreads generally involve a long position in a futures contract on a specified commodity in a given delivery month with a contemporaneous short position on a different (but related) commodity with the same delivery month.

⁶ See Part II.B of the Final Rule.

⁷ Position limits for cash-settled NYMEX Henry Hub Natural Gas contracts are set differently from other Referenced Contracts due to the very active cash-settled market in natural gas as compared to the cash-settled market in other commodities. See Part II.D.3 of the Final Rule.

⁸ See 17 C.F.R. Part 151.4(a).

Physically-settled and cash-settled positions cannot be netted to determine whether spot-month position limits have been exceeded.⁹ Spot-month limits will be effective 60 days following the definition of “swap” pursuant to section 721 of the Dodd-Frank Act, with initial spot-month position limits set out in the Final Rule. From January 1 of the second year following effectiveness of spot-month position limits, the limits for energy and metal contracts will be set by the CFTC biennially and for all other contracts on annual basis using data supplied by DCMs.¹⁰

Non-Spot-Month Position Limits

Non-spot-month position limits apply to aggregated positions in all available trading months combined as well as to positions in a single month. For each Referenced Contract, the non-spot-month position limit will be set at 10% of the open interest in the first 25,000 contracts and 2.5% of the open interest thereafter.¹¹ All positions in a Referenced Contract will be netted to determine whether the non-spot-month position limits have been exceeded.¹² The initial non-spot-month position limit will be effective once the CFTC has obtained sufficient data to determine the all-months combined aggregate open interest for 12 months. The limits will be updated biennially based on the higher of (i) the most recent 12 month average of the all-months combined aggregate open interest and (ii) the 24 month average of the all-months combined aggregate open interest. Open interest includes all open interest in futures and options contracts as well as both cleared and uncleared swaps.¹³

Aggregation

In calculating a trader’s total position in a Referenced Contract, the Final Rule requires the aggregation of positions across accounts held or controlled by such trader, including accounts in which a trader holds at least a 10% equity interest, as well as funds or accounts in multiple pools with identical trading strategies held or controlled by such trader. Exemptions exist for independent account controllers¹⁴ and commodity pool operators that do not control the pool’s trading decisions.¹⁵

⁹ 17 C.F.R. Part 151.4(c)(1).

¹⁰ 17 C.F.R. Part 151.4(d).

¹¹ 17 C.F.R. Part 151.4(b)(1).

¹² 17 C.F.R. Part 151.4(b).

¹³ 17 C.F.R. Part 151.4(b)(2), 151.4(d)(3).

¹⁴ The independent account controller exemption is available to any person:

“(1) Who specifically is authorized by an eligible entity independently to control trading decisions on behalf of, but without the day-to-day direction of, the eligible entity; (2) Over whose trading the eligible entity maintains only such minimum control as is consistent with its fiduciary responsibilities for managed positions and accounts to fulfill its duty to supervise diligently the trading done on its behalf or as is consistent with such other legal rights or obligations which may be incumbent upon the eligible entity to fulfill; (3) Who trades independently of the eligible entity and of any other independent account controller trading for the eligible entity; (4) Who has no knowledge of trading decisions by any other independent account controller; and (5) Who is registered as a futures commission merchant, an introducing broker, a commodity trading advisor, or an associated person of any such registrant, or is a general partner of a commodity pool the operator of which is exempt from registration”.

¹⁵ 17 C.F.R. Part 151.7.

Bona Fide Hedging

The Final Rule includes an exemption from position limit rules for bona fide hedging transactions. For a Referenced Contract to qualify as a bona fide hedging transaction, it must be an enumerated hedging transaction¹⁶ that hedges inventory holdings in, or merchandising transactions, royalties or service contracts related to, an underlying physical commodity or anticipatory trades in the physical commodity.¹⁷ Bona fide hedging transactions also include the purchase or sale of a Referenced Contract that mitigates the risks of a position resulting from a swap that was entered into with a counterparty for whom the swap would qualify as a bona fide hedging transaction (“pass-through swaps”). Both parties to a pass-through swap can qualify for the bona fide hedging exemption. The Final Rule also allows for market participants to petition the CFTC to amend the current list of enumerated swaps or the other conditions to the bona fide hedging exemption.¹⁸

Pre-Existing Positions

Futures, options and swaps entered into in good faith prior to the effective date of the Final Rules are exempt from the non-spot-month position limits only.¹⁹ To the extent pre-existing positions in a Referenced Contract exceed the non-spot-month position limit for such Referenced Contract, such positions alone will not violate the position limit rules. However, additional transactions that would further increase a position cannot be executed until the position is reduced below the applicable position limit. For pre-existing positions below the applicable position limit for a Referenced Contract, additional positions may be acquired up to the applicable position limit, aggregating both pre-existing and any new positions.

The Final Rule provides a broader exemption for swaps in Referenced Contracts entered into prior to the effective date of the Dodd-Frank Act. Such swaps are not subject to any position limits established in the Final Rule and will not count toward exceeding any position limits through the establishment of new positions. These swaps may (but are not required to) be netted against post-effective swaps for the purpose of applying any applicable position limit.²⁰

Order to Amend Effective Date for Swap Regulation

The general effective date for most provisions under Title VII of the Dodd-Frank Act that do not require rulemaking was July 16, 2011. To address the concerns of some market participants as to the legal uncertainty created by the effectiveness of a new regulatory regime without finalized rules and regulations, on July 14, 2011 the CFTC issued an order granting temporary relief from the impact of certain provisions of the Dodd-Frank Act until December

¹⁶ Enumerated hedging transactions include: (i) purchases or sales of Referenced Contracts that hedge actual or anticipated exposure to the underlying commodity, (ii) purchases or sales of Referenced Contracts that hedge a cash commodity that is anticipated to be merchandised, (iii) purchases or sales of Referenced Contracts that hedge anticipated royalties, (iv) purchases or sales of Referenced Contracts that hedge the change in value of receipts or payments due or expected to be due under a services contract and (v) purchases or sales of Referenced Contracts that are cross-commodity hedges.

¹⁷ 17 C.F.R. Part 151.5(a)(1)-(2).

¹⁸ 17 C.F.R. Part 151.5(a)(5).

¹⁹ 17 C.F.R. Part 151.9(a)-(b).

²⁰ 17 C.F.R. Part 151.9(c).

31, 2011 or until such earlier time at which a final rule becomes effective (the "July 14 Order").²¹ Many final rulemakings by the CFTC will not be in place by December 31, 2011 when the current temporary exemptive relief expires. The Proposed Order would extend the temporary exemptive relief previously granted to swap market participants from various requirements under the CEA, as amended by the Dodd-Frank Act to July 16, 2012 or until such earlier time at which a final rule becomes effective.

Scope of Exemption Proposed by the CFTC

The Proposed Order provides temporary relief in relation to two types of provisions of the Dodd-Frank Act: (1) self-effectuating provisions that reference terms requiring definitional rulemakings and (2) self-effectuating provisions that repeal certain provisions of current law. The proposed exemptive relief maintains the status quo with regard to the nature and scope of the July 14 Order while expanding the exemption to include transactions that fully meet the requirements of the existing Part 35 of the CFTC regulations.²²

Self-Effectuating Provisions Referencing Terms Requiring Further Definition – Certain provisions of the Dodd-Frank Act reference terms that are subject to further rulemakings (i.e. "swap," "swap dealer," "major swap participant," and "eligible contract participant").²³ As these definitional rulemakings will not be finalized by December 31, 2011, the CFTC proposes to exempt market participants from complying with provisions of the CEA (as added or amended by the Dodd-Frank Act) to the extent such provisions specifically relate to terms awaiting further definitional rulemakings. The proposed exemptions expire upon the earlier of the effective date of a final definitional rule or July 16, 2012.

Self-Effectuating Provisions Repealing Exemptions and Exclusions in the CEA – Currently, the CEA provides for the exclusion or the exemption of certain transactions between eligible parties in financial and other non-agricultural commodities (such as metals, chemicals and energy) from CFTC oversight. Many of these exemptions have been added to the CEA by the Commodity Futures Modernization Act of 2000.²⁴ As of July 16, 2011 these exclusions and exemptions were repealed. However, other established regulatory exemptions and safe harbors, most notably the CFTC's Swap Policy Statement,²⁵ and Parts 32 and 35 of the CFTC regulations²⁶ continued to be available to transactions that met the conditions therein until such regulatory exemptions and safe harbors were repealed or replaced. To compensate for the repeal of the broader exemptions under the CEA on July 16, 2011, the July 14 Order expanded the scope of the Swap Agreement Exemption and extended temporary relief from the CEA to transactions that may fail to satisfy one or more

²¹ For a complete discussion of the original CFTC order granting temporary exemptive relief see Client Memorandum entitled "CFTC, SEC Propose to Delay the Applicability of Certain Swap Provisions of the Dodd-Frank Act" available at <http://www.paulweiss.com/files/upload/17-Jun-11Alert.pdf>.

²² 17 C.F.R. Part 35 ("Part 35" or "Swap Agreement Exemption").

²³ See sections 712(d) and 721(c) of the Dodd-Frank Act.

²⁴ See sections 2(d), 2(g), 2(h) 2(e) and 5(d) of the CEA.

²⁵ See Commodity Futures Trading Commission, Statement of Policy Concerning Swap Transactions, 54 Fed. Reg. 30694 (July 21, 1989) (the "Swap Policy Statement").

²⁶ See 17 C.F.R. Part 32 ("Part 32") and 17 C.F.R. Part 35 ("Part 35" or "Swap Agreement Exemption").

prongs of the Swap Agreement Exemption but otherwise fall within the scope of the CEA exemptions (as in effect prior to July 16, 2011). The CFTC recently promulgated a rule that will repeal the Swap Agreement Exemption effective December 31, 2011. To ensure that the exemptive relief currently available continues to be available following the effective repeal of the Swap Agreement Exemption, the CFTC is proposing to include within the temporary exemptive relief any transaction that fully meets the conditions of the Swap Agreement Exemption as in effect on December 31, 2011. The Proposed Order no longer would limit the relief to excluded or exempt commodities; agricultural commodities that fully meet the conditions of Part 35 also would be exempted. This proposed exemptive relief would be available until the earlier of July 16, 2012 or such other compliance date as may be determined by the CFTC.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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