

CFTC Position Limits and Aggregation Under Dodd-Frank

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Introduction

The Commodity Futures Trading Commission (CFTC) has used speculative position limits as a tool to regulate the futures markets for over 70 years, and Congress has repeatedly expressed confidence in the use of speculative position limits as an effective means of preventing unreasonable and unwarranted price fluctuations in the commodities markets. Congress conferred broad authority upon the CFTC to set position limits, but when setting position limits, the CFTC is guided by the following goals: (i) diminishing, eliminating, or preventing excessive speculation; (ii) deterring and preventing market manipulation, squeezes, and corners; (iii) ensuring sufficient market liquidity for bona fide hedgers; and (iv) ensuring that the price discovery function of the underlying market is not disrupted. On July 21, 2010 the Dodd-Frank Act (DFA) was enacted into law. The DFA expanded the CFTC's authority to set position limits and authorized the CFTC to establish position limits not just for futures and option contracts, but also for swaps that are economically equivalent to covered futures and options contracts, whether or not the swaps are traded on a designated contract market or swap execution facility.

The CFTC's adoption of position limits, however, has not been smooth. The CFTC adopted final rules on November 18, 2011, establishing position limits on

28 exempt and agricultural commodity futures and options contracts and the physical commodity swaps that are economically equivalent to such contracts. Yet, on September 28, 2013 the United States District Court for the District of Columbia vacated those same position limits due to the perceived failure of the CFTC to engage in an appropriate analysis of its rules. Since that time, the CFTC has re-proposed position limit rules and position limit aggregation rules and extended the public comment period for these rules. The most recent comment period for the proposed rules is now closed, and at the time of this article, it remains to be seen whether the rules will be adopted as proposed.

Proposed Position Limits

As proposed, position limits would apply to certain agricultural commodities (such as corn, oats, soybeans, wheat, cotton, rice, milk, cattle, hogs, cocoa, coffee, sugar, and frozen concentrated orange juice), energy commodities (such as Henry Hub natural gas, light sweet crude oil, New York Harbor ultra low sulfur diesel, and RBOB gasoline) and metal commodities (such as copper, gold, silver, palladium, and platinum). The position limits would apply to spot-month contracts, single month contracts, and all month contracts. Additionally, the position limits would apply to swaps that are economically equivalent to such contracts. A swap is consid-

ered to be economically equivalent to a futures contract if the swap is either linked to the price of the futures contract or linked to the price of the applicable commodity at the delivery location specified in the futures contract.

Position limits do not apply to *bona fide* hedging transactions. *Bona fide* hedging transactions generally require that (i) the contract or swap transaction represents a substitute for transactions made or to be made or position taken or to be taken at a later time in a physical marketing channel; (ii) the transaction be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; (iii) the transaction arises from the potential change in the value of an asset, liability, or service that a person owns, produces, manufactures, incurs, provides, or purchases (or expects to do so); or (iv) the transaction reduces risks of a position resulting from a swap which constitutes a *bona fide* hedging transaction. Even if such tests are satisfied, however, in order for a transaction to be considered to be a *bona fide* hedging transaction, the transaction must be established and liquidated in an orderly manner in accordance with sound commercial practices. As a result of the foregoing test, it is likely that most advisers will not be able to characterize their trading as *bona fide* hedging transactions.

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Proposed Aggregation Rules

The speculative position limit rules would generally be applied to a person and its affiliates on a global basis and would not simply be limited to a single legal entity. Without an exemption as described below, a person generally must aggregate all positions in accounts for which the person, by power of attorney or otherwise, directly or indirectly, controls trading or holds a ten percent or greater ownership or equity interest. A person must also aggregate positions over which it controls trading pursuant to an express or implied agreement or understanding. Finally, a person must aggregate all positions in multiple pools with substantially identical trading strategies if the person holds or controls those trading positions. For an investment adviser, the aggregation rules can be potentially troublesome, particularly because it is unlikely that the adviser's transactions would constitute bona fide hedging transactions.

Relief From Aggregation

Relief from the general aggregation rules would be available in certain circumstances. Some of those circumstances are described below.

First, positions would not have to be aggregated if a person uses an independent account controller to manage the positions. An independent account controller must be registered as a futures commission merchant, an introducing broker, a commodity trading advisor (or an associated person of any such entity). Additionally, the independent account controller could be the general partner of a commodity pool where the commodity pool operator is exempt from regulation as such under CFTC Regulation 4.13. An independent account controller must trade independently from the person seeking to disaggregate the positions of the independent account controller and the person cannot exercise day-to-day control over the trading of the independent account controller.

This relief would not apply to spot month limits in physical contracts, however, so it is not a perfect solution to an aggregation problem.

Second, a person does not have to aggregate positions held in pooled accounts where a person has a ten percent or greater interest in the commodity pool, unless the person (i) is the commodity pool operator, (ii) a principal or affiliate of the commodity pool operator, or (iii) holds a 25% or greater ownership interest in a commodity pool where the commodity pool operator is exempt from registration as such under CFTC Regulation 4.13.

Third, in situations where a person has an ownership or equity interest in an account that is greater than ten percent but not more than 50%, relief from aggregation is available provided that the person (i) cannot have knowledge of the trading decisions of the account, (ii) has trading systems that are independent from those of the account, (iii) has written procedures for information barriers with the account, (iv) may not share employees that control trading decisions of the account, and (v) cannot have risk management systems that share information with the account.

Persons seeking any of the exemptions described above must file a notice with the CFTC that includes a description of the relevant circumstances that warrant disaggregation and a statement of a senior officer that the conditions set forth in the exemption have been met. Upon submission of the notice to the CFTC, these exemptions become effective.

Fourth, in situations where a person has an ownership or equity interest in an account that is greater than 50%, relief from aggregation is available upon application to and approval by the CFTC provided that the person (i) satisfies all of the requirements for relief of a greater than ten percent holder described above, (ii) certifies that the account is not and is not required to be consolidated with the person, (iii) must demonstrate to the CFTC that proce-

dures are in place that are reasonably effective to prevent coordinated trading decisions between the person and the account, (iv) must have each representative on the board of directors certify that such director does not control the account, (v) must certify either that all positions in the account are *bona fide* hedging transactions or that speculative trading positions do not exceed 20% of any position, and (vi) must agree to have the account provide information to the CFTC upon a special call for information. A person seeking this relief must file a request with the CFTC, which shall not become effective unless and until the CFTC finds, in its discretion, that the person has satisfied all of the conditions for exemption. The request must contain (a) a description of the relevant circumstances that warrant disaggregation, (b) a statement of a senior officer that the conditions set forth in the exemption have been met, (c) a demonstration that procedures are in place that are reasonably effective to prevent coordinated trading decisions by such person, any person that such person must aggregate, and the owned account, and (d) the certifications described above for such exemption.

There are additional exemptions from position limits for broker-dealers, underwriters, and persons who are prohibited by law from sharing information with respect to an account, which may be available depending upon relevant factual circumstances.

If an owned account has filed a notice with the CFTC for an exemption, then any person with an ownership or equity interest of ten percent or greater in the owned account need not file a separate notice identifying the same positions and accounts previously identified in the notice filing of the owned account, provided that (i) such person complies with the conditions applicable to the exemption specified in the owned account's notice filing, (ii) such person does not otherwise control trading of

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the accounts or positions identified in the notice, and (iii) upon call by the CFTC such person provides to the CFTC information pertaining to such person's claim for exemption.

Conclusion

Despite a few setbacks, the CFTC is certain to adopt final position limit and aggregation rules in the near future. Ad-

visers need to be aware of these rules, how the rules may impact existing trading strategies and whether any relief would be available to prevent disruption in existing trading strategies.

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