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End User Issues
January 25, 2019
8:00 a.m. – 9:00 a.m.

Chair:
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Panel:
Vince Johnson (BP)
Bill McCoy (Morgan Stanley)
David Mitchell (Fried Frank)
Deanna Reitman (DLA Piper)
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CFTC Proposes SEF Rule Amendments, Requests Comment on Post-Trade Name Give-up, and Retains $8b Swap Dealer De Minimis Threshold

American Bar Association
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Derivatives and Futures Law Committee
Winter Meeting
Panel on End Users

January 24-26, 2019
LaPlaya Beach & Golf Resort
Naples, FL 34108

David S. Mitchell
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On November 5, 2018, the Commodity Futures Trading Commission (“CFTC” or “Commission”) held its first meeting with a full roster of commissioners since May 2013. At the meeting, the Commission (1) proposed a significant overhaul of the rules governing swap execution facilities (“SEFs”), including the trade execution requirement; (2) requested public comment on whether it should prohibit the practice of identifying counterparties to cleared SEF swap trades after such trades have been executed; and (3) voted in favor of permanently retaining the current $8 billion de minimis threshold for swap dealer registration, which was otherwise scheduled to drop to $3 billion on January 1, 2020.

Proposed Amendments to the SEF Rules

In light of its experience and feedback received on the rules governing SEFs adopted in 2013¹ (the “Current SEF Rules”), the Commission is proposing rules² (the “Proposed Rules”) that aim to promote greater flexibility, efficiency and transparency for market participants using SEFs and for SEFs themselves. The Commission voted 4-1 in favor of the Proposed Rules, with Commissioner Berkovitz dissenting. Comments on the Proposed Rules must be received on or before February 13, 2019.³

Additional Types of Swaps Would Need to be Traded on SEFs and DCMs

Under the Proposed Rules, a greater number of swaps would need to be traded on SEFs and DCMs. Under the existing process, swap transactions that are subject to the mandatory clearing requirement in Commodity Exchange Act (“CEA”) Section 2(h)(1) must be executed on a designated contract market (“DCM”), a registered SEF, or a SEF that is exempt from registration pursuant to CEA Section 5h(g) (an “Exempt SEF”), unless no DCM or SEF “makes the swap available to trade” (i.e., “MATs” the trade) or the transaction qualifies for a clearing exception pursuant to CEA Section 2(h)(7). The MAT process requires the SEF or DCM to file a determination with respect to a swap with the Commission (pursuant to the Commission’s Section 40.5 rule approval process or Section 40.6 certification process), after which market participants are given the opportunity to comment on the determination. If the determination subsequently becomes effective, the swap is then publicly listed in a database on the CFTC’s website. Many types of swaps are currently listed by SEFs and DCMs, but without having received MAT determinations.⁴ The Commission observed that the swaps that have received MAT determinations...


³ As noted subsequently, comments on the post-trade name give-up proposal are due on or before January 29, 2019.

⁴ For a list of MAT determinations that have been submitted to the Commission, see CFTC, Industry Oversight, Industry Filings, Swaps Made Available to Trade Determination, https://sirt.cftc.gov/sirt/sirt.aspx?Topic=%20SwapsMadeAvailableToTradeDetermination. For a current list of swaps that have been made “available to trade” and are subject to the existing trade execution requirement, see CFTC, Industry Oversight, Industry Filings, Swaps Made Available to Trade, https://www.cftc.gov/sites/default/files/idc/groups/public/@otherif/documents/file/swapsmadeavailablechart.pdf. For a list of swaps subject to the clearing requirement, see 17 CFR 50.4; see also CFTC, Industry Oversight, Industry Filings, Swaps Subject to Clearing Requirement,
determinations so far - “on-the-run” index credit default swaps (“CDS”) and fixed-to-floating interest rate swaps (“IRS”) in benchmark tenors - are generally the most standardized and liquid contracts.

Under the Proposed Rules, if a swap is (or becomes) subject to mandatory clearing, it must be traded on a SEF or DCM, subject to certain exceptions (including the end-user exception from clearing)\(^5\), unless no SEF or DCM lists it for trading (in which case it can continue to be traded bilaterally) (the “New Trade Execution Requirement”). As a result, certain categories of IRS and CDS that are currently subject to mandatory clearing - but that have not yet received MAT determinations by any SEF or DCM - would need to be traded on a SEF or DCM unless no SEF or DCM lists it. The MAT process would be eliminated.

The Commission is proposing a phased-in compliance timeline for various types of trading counterparties to begin trading such cleared products on SEFs or DCMs. Category 1 entities (e.g., swap dealers) would have 90 days from the effective date of final rules to come into compliance; Category 2 entities (e.g., commodity pools, private funds as defined in Section 202(a) of the Investment Advisers Act of 1940, and persons predominantly engaged in activities that are financial in nature) would have 180 days to comply; and all other entities (e.g., separate account clients that are not Category 1 or 2 entities, etc.) would have 270 days to comply.

Additionally, to make the process more transparent for market participants, the Commission proposes to create an online registry that will specify the swaps that are subject to the New Trade Execution Requirement and the SEFs and DCMs that list such swaps.\(^6\)

**Trades Could Be Executed on SEFs in More Ways**

To encourage more trading of swaps on SEF and DCM platforms, the Commission hopes to facilitate trade execution and increase market liquidity by making the process easier. Currently, trades on SEFs and DCMs that are subject to the existing trade execution requirement (i.e., that must be cleared and have received MAT determinations) can only be executed using an Order Book\(^7\) or request-for-quote (“RFQ”) system that sends a request-for-quote to no less than three unaffiliated market participants and operates in conjunction with the Order Book. Trades that are

\(^5\) Specifically, under the Proposed Rules, the following types of transactions would be exempt from the New Trade Execution Requirement: (i) swap transactions involving swaps that are listed for trading only by an Exempt SEF (as defined in the Proposed Rules); (ii) swap transactions for which the clearing exceptions in CEA Section 2(h)(7) or the clearing exceptions or exemptions under part 50 apply; (iii) swap transactions that are executed as a component of a package transaction that includes a component that is a new issuance bond; and (iv) swap transactions between “eligible affiliate counterparties” (“inter-affiliate counterparties”) that elect to clear such transactions, notwithstanding their ability to elect the relevant clearing exemption under §50.52. (See the Proposed Rules at 62037.)

\(^6\) See the Proposed Rules at 62041.

\(^7\) An Order Book is defined as (i) an “electronic trading facility,” as that term is defined in CEA Section 1a(16); (ii) a “trading facility,” as that term is defined in CEA Section 1a(51); or (iii) a trading system or platform in which all market participants have the ability to enter multiple bids and offers, observe or receive bids and offers entered by other market participants, and transact on such bids and offers. 17 CFR 37.3(a)(3).
not subject to the existing trade execution requirement (referred to as “Permitted Trades”) can be executed through any method.

Under the Proposed Rules, counterparties trading on SEFs and DCMs could execute all trades through any available method, and SEFs would need to disclose to participants how each method operates. The Commission hopes this approach will promote pre-trade price transparency by allowing execution methods that maximize participation and concentrate liquidity during times of episodic liquidity.

However, this flexibility is somewhat tempered by a proposed prohibition on pre-arranged trading and pre-execution communications outside of SEF platforms. Specifically, with the exception of package transactions, trades subject to the New Trade Execution Requirement would need to be both arranged and executed on a SEF, rather than merely executed on a SEF as pre-arranged trades or as trades arranged via an introducing broker away from the SEF. The Commission also proposes to eliminate the existing exceptions to the pre-arranged trading prohibition, including (i) the 15-second time delay requirement under Section 37.9(b); (ii) the exception for block trades under Section 37.203(a); and (iii) the exception for “other types of transactions” under Section 37.203(a).

As a result, as a general matter, SEFs would no longer be permitted to adopt and enforce rules which allow participants to pre-arrange or pre-negotiate a trade and then submit it to an Order Book for execution pursuant to a time delay. The Commission hopes that increasing the methods through which trades can be executed on SEFs will obviate the need for pre-arranged trades. Note that this proposed prohibition would not apply to a swap that is either (1) not subject to the New Trade Execution Requirement or (2) part of a package transaction that includes a component that is not subject to the New Trade Execution Requirement.

Although it may appear that the prohibition on pre-arranged trades is at odds with the Commission’s goals of facilitating trading activity and liquidity formation, particularly in light of the proposed, broadened trade execution requirement, the Commission explained that “with an expanded scope of swaps subject to the [New Trade Execution Requirement], the Commission is concerned that allowing a disproportionate amount of SEF transactions to be pre-arranged or pre-negotiated away from the facility under the pretense of trading flexibility would undercut the import of the expansion of the requirement. Without a limitation on pre-execution communications that occur away from the SEF, the SEF’s role in facilitating swaps trading is also diminished and would undermine the statutory goals of promoting greater swaps trading on SEFs and promoting pre-trade price transparency.”

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8 See the Proposed Rules at 61983.
9 See id. at 61952.
10 See id. at 62042 - 62044 for further discussion of the block trade proposal.
11 See id. at 61986.
12 Id. at 61987.
Access to SEFs Would Change

Under the Current SEF Rules, SEFs are required to provide impartial access to their trading platforms to all market participants. Under the Proposed Rules, the Commission has reinterpreted the “impartial access” mandate to mean that SEFs can establish differing participation criteria and trading practices, so long as they are applied in a transparent, fair, and non-discriminatory manner to “similarly situated” market participants. Therefore, in theory, a SEF could be established as a dealer-to-dealer platform. Similarly, fee structures could be established on a more bespoke basis between SEFs and their customers based on “legitimate business negotiations”, as long as the SEF does not use fees to discriminate against certain market participants.

Asset Managers’ Clients Would No Longer be Classified as SEF “Participants”

In the Proposed Rules, the Commission has clarified that clients of asset managers would not be considered “market participants” of a SEF on which such asset managers trade with full discretion as agents on behalf of their clients. Asset managers would still be considered “market participants” (and, among other things, be subject to the recordkeeping requirements of Section 37.404(b) of the Commission’s rules), but the SEFs’ jurisdiction would not extend to the asset managers’ clients, unlike at present.

More Entities Would Need to Register as SEFs

Under the Proposed Rules, interdealer brokers for swaps and aggregators of single-dealer swap platforms would need to register as SEFs. In particular, the SEF registration requirement in CEA Section 5h(a)(1) and Section 37.3(a) of the Commission’s rules would apply to swaps broking entities, including interdealer brokers, that are currently registered with the Commission as introducing brokers (“IBs”), and their personnel currently facilitating swaps trading away from SEFs. The Proposed Rules also clarify that the New Trade Execution Requirement is not a determinant of whether an entity must register as a SEF by codifying the Commission’s existing interpretation (contained in footnote 88 of the preamble to the Current SEF Rules) that an entity must register as a SEF if it permits trading or execution of any swap, including swaps that are not subject to the New Trade Execution Requirement, in a manner consistent with the statutory SEF definition (i.e., trading or execution on a “multiple-to-multiple” basis among market participants).

The Commission proposes a six month delay before any such registration requirements become effective for U.S. entities, subject to certain conditions (including that any swaps traded on a swaps broking entity that is subject to registration would need to be routed for execution on

______________________________

13 See id. at 61993.
14 See id. at 61995.
15 See id. at 61997.
16 See id. at 61955.
a SEF in the meantime). Foreign entities would be provided with a two year delay, again subject to certain conditions.\textsuperscript{17}

\textit{Regulation of “SEF Trading Specialists”}

The Proposed Rules would also establish a new category of market professionals who perform certain core functions that facilitate swaps trading and execution for a SEF (known as “SEF trading specialists”). SEF trading specialists would not need to be registered with the CFTC, but prior to appointing such specialists, SEFs would need to adopt (i) fitness qualifications that prohibit certain persons (such as those subject to statutory disqualification under the CEA) from acting as SEF trading specialists; (ii) proficiency testing; (iii) ethics training; and (iv) a code of conduct for such personnel. SEFs would be required to supervise SEF trading specialists.

\textit{Swap Documentation}

Currently, Section 37.6(b) of the Commission’s rules requires a SEF to provide each counterparty to a cleared or uncleared transaction with a written “confirmation” that contains all of the terms at the time of the swap’s execution, including (i) “economic terms” that are transaction specific (e.g., swap product, price, and notional amount) and (ii) non-specific “relationship terms” that generally govern all transactions between two counterparties (e.g., default provisions, margin requirements, and governing law).\textsuperscript{18}

To lessen the financial, administrative, and logistical burdens associated with this requirement, the Commission is proposing separate swap documentation rules for cleared swaps and uncleared swaps. The existing documentation requirement (i.e., the SEF must issue a written confirmation that includes all of the terms of the transaction) would still apply to cleared swaps. However, for uncleared swaps, SEFs would only need to provide a “trade evidence record” – which, at minimum, would need to include the economic terms that were agreed upon between the counterparties.\textsuperscript{19} Additionally, both types of confirmations would now need to be provided “as soon as technologically practicable”, rather than at the same time as trade execution.\textsuperscript{20}

\textit{SEFs’ Authority and Ability to Collect Information}

Under the Current SEF rules, SEFs have the authority to collect documents from their participants on a routine and non-routine basis and to examine books and records kept by persons under investigation. The Commission proposes limiting the scope of this authority solely to the collection of information required to be kept by persons subject to the SEF’s recordkeeping rules.\textsuperscript{21}

However, the Proposed Rules would expand existing recordkeeping requirements. Section 37.404(a) of the Commission’s existing rules provides that a SEF must demonstrate that it has access to sufficient information to assess whether trading (i) in swaps that it lists; (ii) in the index

\begin{itemize}
\item \textsuperscript{17} The Commission acknowledges that a substituted compliance regime with the regulations of such foreign entities’ home jurisdictions will likely be necessary.
\item \textsuperscript{18} See id. at 61972.
\item \textsuperscript{19} See id. at 61973.
\item \textsuperscript{20} See id. at 61973 - 61974.
\item \textsuperscript{21} See id. at 61998.
\end{itemize}
or instrument used as a reference price; or (iii) in the underlying commodity for its listed swaps is being used to affect prices on its market. Section 37.404(b) of the Commission’s rules further requires a SEF to have rules that require its market participants to keep records of their trading, including records of their activity in the index or instrument used as a reference price, the underlying commodity, and related derivatives markets; and make those records available to the SEF, its regulatory service provider if applicable, and the Commission. The Commission previously specified in the guidance to Core Principle 4 that a SEF could limit the application of these requirements solely to market participants who conduct “substantial trading” on its facility. Now, the Commission is proposing to remove the reference to “substantial trading” - so all participants would need to comply with these recordkeeping rules.22

Error Trade Policy

In 2013, the Commission issued guidance to address “straight-through processing” requirements and clarified that SEFs should have rules stating that any trade that is rejected from clearing is “void ab initio”.23 This view meant that all swaps transactions rejected from clearing by a DCO would be considered void, even if the rejection was due to an operational or clerical error. In practice, this policy has resulted in frustration for counterparties and inefficiency in the market, since even a minor typographical error in one counterparty’s name could result in a voided trade.

The Commission is proposing to explicitly permit SEFs to establish their own rules regarding error trades rejected from clearing, subject to a requirement that rejected swaps be void ab initio if the DCO rejects the trade due to credit reasons. The Commission is also proposing to (i) further define an “error trade”24 to create consistency across SEFs; (ii) require SEFs to establish and maintain rules to resolve error trades in a fair, transparent, consistent, and timely manner; (iii) require SEFs to notify participants as soon as practicable of any swap transaction that is under review as an error trade, and the determination and resolution of any such situation; and (iv) allow SEFs to establish non-reviewable ranges, which could be adjusted based on market conditions, as long as they are established and maintained in a fair, transparent, consistent, and timely manner.25

Information Sharing

SEFs are currently required to share information with other regulatory organizations, data repositories, and third-party data reporting services as required by the Commission or as otherwise necessary and appropriate to fulfill their self-regulatory and reporting responsibilities.26 The Commission is proposing to remove the prescribed list of entities with which SEFs may share

22 See id. at 62016.

23 See id. See also CFTC Staff Guidance on Swaps Straight-Through Processing at 5 (Sept. 26, 2013) (the “2013 Staff STP Guidance”).

24 The Proposed Rules define an “error trade” as any swap transaction executed on a SEF that contains an error in any term, including price, size, or direction. See the Proposed Rules at 62001.

25 See id. at 62001 - 62002.

26 17 CFR 37.504.
information and instead allow SEFs to generally share information, as required by the Commission, or as appropriate to fulfill their self-regulatory and reporting responsibilities.  

*Straight-Through Processing Requirements*

The Commission is also proposing certain modifications to the rules governing the interaction between SEFs and DCOs and the timing of the clearing process itself.

First, the Commission proposes to amend Section 37.701 of its rules to require a SEF to establish a direct and independent clearing agreement with each registered DCO or exempt DCO to which the SEF submits swap transactions for clearing, which would prohibit SEFs from routing trades through third-party service providers, absent a clearing agreement with that DCO.

Second, the Commission is proposing certain changes to facilitate “straight-through processing” of cleared transactions, which the Commission’s Divisions have described as “near-instantaneous acceptance or rejection of each trade.” Under the Current SEF Rules, for cleared swaps (i) each SEF must coordinate with the relevant DCO to develop rules and procedures to facilitate “prompt and efficient” transaction processing in accordance with the requirements of Section 39.12(b)(7) of the Commission’s rules and (ii) each registered DCO must coordinate with a relevant SEF or DCM to develop rules and procedures to facilitate “prompt, efficient, and accurate” transaction processing. Note that the requirement applicable to DCOs includes the word “accurate” in the standard, while the SEF requirement does not. Separately, under the Current SEF Rules, a DCO must accept or reject a transaction for clearing as quickly as technologically practicable as if fully automated systems were used (the “AQATP” timing standard). In the 2013 Staff STP Guidance, the Commission clarified that the AQATP timing standard means within ten seconds after the trade is submitted to the DCO. A subsequent staff letter clarified that the AQATP timing standard for transactions routed to an affirmation hub would be satisfied if the transactions were routed to and received by the DCO no more than ten minutes after execution.

The Commission is proposing to clarify that (i) the “prompt, efficient and accurate” standard would apply to each SEF and each registered DCO with respect to activities related to the processing and routing of cleared swaps to the DCO and (ii) the AQATP timing standard would not apply to the processing and routing of transactions. As a result, the ten minute routing timeframe discussed above would be replaced with the “prompt, efficient and accurate” standard. However, the AQATP timing standard would still apply to a DCO’s acceptance or rejection of a transaction for clearing upon submission to the DCO, and this timing standard would apply upon the submission of the trade to the DCO.

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27 See the Proposed Rules at 62017 - 62018.

28 See id. at 62019.

29 Id. at 62020.


31 See the Proposed Rules at 62022.
Finally, the Commission is proposing to codify staff guidance that (i) each market participant must identify a clearing member in advance and (ii) the SEF must facilitate pre-execution credit screening of trades.\(^{32}\)

**SEF Compliance and Self-Regulatory Organization (“SRO”) Oversight and SEF Financial Resource Requirements**

The Proposed Rules would also streamline many SEF SRO obligations and provide a SEF with the ability to tailor its rule enforcement program, disciplinary procedures, and sanctions to its trading operations and market. Under the Proposed Rules, (i) a SEF would be able to choose additional types of entities to serve as a regulatory service provider to assist with fulfilling its compliance responsibilities; (ii) further streamline a SEF chief compliance officer’s (“CCO”) existing duties; (iii) simplify the preparation and submission of a SEF’s annual compliance report; and (iv) provide a SEF’s senior officer (i.e., the CEO or equivalent officer) with the same oversight responsibilities over the CCO as the SEF’s board. Additionally, the Commission is proposing several amendments to Form SEF, the form that applicants must complete to register as a SEF or amend their registration, including eliminating certain exhibits to the form.

The Proposed Rules would also (i) amend the financial resources requirements to clarify that a SEF would only need to maintain adequate financial resources to cover the operating costs needed to comply with the SEF core principles and Commission regulations for a one-year period, as calculated on a rolling basis and (ii) amend the existing liquid resource requirement from six months of a SEF’s operating costs to the greater of (A) three months of a SEF’s projected operating costs; or (B) the projected costs for a SEF to wind down its business, as determined by the SEF.

**Request for Comment on Post-Trade Name Give-Up Policies**

The Commission voted 5-0 to request public comment on whether counterparty names should be disclosed after a trade has been anonymously matched on a SEF and is intended to be cleared by a DCO (referred to as “post-trade name give-up”).\(^{33}\)

While post-trade name give-up has been a common practice for uncleared swaps, the Commission observed that the need for name disclosure for cleared swaps is less obvious because the intermediation by a DCO effectively eliminates individual credit risk and counterparty exposure. Moreover, cleared swaps are subject to pre-execution credit checks and straight-through processing requirements. Nevertheless, post-trade name give-up continues in some swaps markets, including those where swaps are anonymously executed and cleared.

The Commission noted that buy-side participants have been concerned about post-trade name give-up policies resulting in information leakage and exposure of participants’ trading intentions, strategies, positions, and other sensitive information.\(^{34}\) Conversely, “other industry participants have claimed that post-trade name give-up is an important tool used to mitigate liquidity risk or the risk that traders will game the market”.\(^{35}\) In light of these opposing views, the

\(^{32}\) See id. at 62023.


\(^{34}\) See id. at 61572.

\(^{35}\) Id.
Commission is soliciting comments relating to the practice of post-trade name give-up, which must be received on or before January 29, 2019.

Making the $8 Billion Swap Dealer Registration Threshold Permanent

The Commission voted 5-0 to adopt a final rule that amends the de minimis exception in paragraph (4) of Section 1.3 of the CFTC’s regulations regarding swap dealers. The CFTC previously adopted a de minimis exception which provided that a person would not be deemed to be a swap dealer unless its swaps dealing activities exceeded an aggregate gross notional amount (“AGNA”) threshold of $3 billion (measured on a group basis over the prior 12-month period). The AGNA threshold, which was initially set at $8 billion for a phase-in period most recently due to expire on December 31, 2019, has now been made permanent at $8 billion.

Therefore, a person will not be deemed to be a swap dealer so long as the swaps connected with its swaps dealing activity - or that of any other entity controlling, controlled by or under common control with the person - during the immediately preceding 12 months do not have an AGNA of more than $8 billion, or an AGNA of more than $25 million where the counterparty is a “special entity” (as that term is defined in Section 4s(h)(2)(C) of the CEA, 7 U.S.C. 6s(h)(2)(C) and Section 23.401(c) of the CFTC’s rules). The final rule became effective on November 13, 2018.

Conclusion

The Commission’s most recent meeting resulted in significant regulatory developments that have the potential to impact the ways in which swaps are traded and to enhance the presence and importance of SEFs in the market in a number of important respects. By streamlining the original SEF rules with the benefit of regulatory experience, the Commission is attempting to make trading on SEFs easier for market participants, and thereby encourage more trading of swaps on SEFs to increase market liquidity, and to make operating a SEF easier for the platforms themselves.

However, certain proposed amendments, such as those pertaining to SEF access for different types of market participants and increased flexibility in trade execution methods, could result in the fragmentation of SEF platforms among various types of customers and diminish pre-trade price transparency, resulting in less overall market liquidity, and less favorable pricing. In his dissent, Commissioner Berkovitz highlighted what he believes to be four principal pitfalls of the Proposed Rules. In his view, the rules would (1) “reduce competition by cementing the oligopoly of the largest bank dealers as the main source of liquidity and pricing in the swaps markets”, (2) “diminish transparency by removing the requirement that highly liquid swaps be traded through competitive methods of trading”, (3) “by reducing competition and diminishing price transparency… increase systemic risks and lead to higher swaps prices for commercial and


37 The Commission originally proposed making the $8 billion threshold permanent in a June 2018 notice of proposed rulemaking (“NPRM”) (See De Minimis Exception to the Swap Dealer Definition, 83 Fed. Reg. 27444 (June 12, 2018)). Notably, the Commission did not address any other issues that were proposed in the June 2018 NPRM in the final rule, but at the November 5, 2018 meeting, Commissioner Giancarlo did note that the staff plans to conduct a study on possible alternative metrics for the calculation of the de minimis threshold, including whether cleared swaps should be removed from the calculation.
financial end-users”, and (4) “provide SEFs with too much discretion to set their own rules and in so doing, weaken regulatory oversight and enforcement capabilities.” Ultimately, comment from both buy-side and sell-side market participants, as well as SEFs and other interested parties, will be essential to ensuring that any final rules arising from the Proposed Rules strike an appropriate balance, advance the Commission’s objectives, and are compatible with the Dodd-Frank Act amendments to the CEA.\(^{38}\)

December 7, 2018

From Inception to Today:  
The Development of Commodity Position Limits in the United States

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1. Introduction

In general, a commodity position limit is the limit placed upon the number of commodity future contracts, swap positions and their equivalents that can be held by one market participant at a particular period of time. In the first part of this paper, we explore the legislative history of the commodity position limit rules and the bona fide hedge exemption. In the second part, we explore the Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") proposals and re-proposals of commodity position limit rules, concluding with an outline of the current commodity position limit rules and including the current bona fide hedging exemption. In the last part, we explore the current state of the position limit rules, including the bona fide hedge exemption, and its impact on market participants.

2. Legislative History of Commodity Position Limits

2.1 Introduction

Since 1936, the Commodity Exchange Act ("CEA") provides that "excessive speculation" in any commodity traded on a futures exchange "causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity is an undue and unnecessary burden on interstate commerce" and, therefore, the Commodity Futures Trading Commission ("CFTC") is empowered to establish such limits on trading "as the [CFTC] finds are necessary to diminish, eliminate, or prevent such burden." 2 This basic concept of the necessity for a federal agency to set position limits ultimately has remained unchanged since the 1936 enactment of the CEA. However, due to the increase in the number of commodities traded on regulated futures exchanges and other changes in the commodity markets, the manner in which position limits are implemented has varied.3

Additionally, since 1936, the CEA has also exempted "bona fide hedging transactions" from any position limits established under the CEA.4 Initially, the CEA defined a "bona fide hedging transaction" as a transaction related to a transaction in the cash market for the commodity.5 Since 1974, however, the CEA has provided the CFTC with discretion to define the term, provided that

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2 7 U.S.C § 6(a) (2010).
3 See 17 C.F.R. §150.5 (2009) by which the CFTC directly fixes the position limits for certain commodities; specifies acceptable practices for the exchanges to establish position limits for other commodities; and also allows the exchanges to use "position accountability levels" rather than fixed position limits in months other than the spot month for commodities that meet certain liquidity requirements.
4 CFTC Regulation 1.3(z), 17 C.F.R. § 1.3(z) (2018).
the CFTC’s definition enables producers, middlemen, and users of a commodity to hedge their legitimate anticipated business needs.\footnote{Id.}

Ever since the collapse of grain prices following the end of the First World War, the U.S. government has discussed the need for commodity position limits. To truly understand the 1936 CEA imposition of commodity position limits, it is important to understand this discussion.\footnote{See Id. (The debate over whether and how to control speculation in the U.S. grain markets can be traced back to the emergence of the organized markets for grain in the mid-19th century; citing William G. Ferris, The Grain Traders: The Story of the Chicago Board of Trade (1988). It was not until the First World War, however, that the Congress actually passed legislation imposing limits on speculation in a commodity market.)}

\subsection{2.2 Food Control Act of 1917}

The first exercise of U.S. federal authority to limit trading in the commodity futures markets occurred when the Congress enacted emergency legislation to stabilize the U.S. grain markets during the First World War. Under the Food Control Act of 1917 the trading of wheat futures was suspended and the U.S. Food Administration\footnote{The U.S. Food Administration was the agency responsible for the administration of the U.S. army overseas and allies’ food reserves during the United States participation in World War I. It was established by Executive Order 2679-A of August 10, 1917, pursuant to the Food and Fuel Control Act. Dan M. Berkovitz, supra note 5.} “secur[ed] a voluntary limitation” of 500,000 bushels on the trading of futures contracts for corn.\footnote{Dan M. Berkovitz, supra note 5 citing Frank M. Surface, The Grain Trade During the World War 224 (1928); Food and Fuel Control Act, Pub. L. 65-41, 40 Stat. 276 authorizes the president to make regulations in order to further national security and defense during wartime by encouraging the production, conserving the supply, and controlling the distribution of food products and fuel.}

\subsection{2.3 Future Trading Act of 1921}

After the First World War, many farmers blamed speculators for the continued depression in grain prices. Many of these farmers sought the re-imposition of limits on futures trading. On the contrary, grain merchants, grain exchanges and others in the grain industry believe that any regulation of the futures markets, including the setting of position limits, would unnecessarily harm the market. A number of bills were introduced in the Congress to regulate the grain markets, and the issue of whether to impose limits on the amount of speculative futures trading was vigorously debated.\footnote{Id. (Many bills to regulate the grain futures markets had been introduced and debated over the previous thirty years, but none had ever made it into law.)}

In May 1921, the House of Representatives passed a bill requiring commodity exchanges to impose limitations on speculative trading as a condition of designation as a contract market. But
the Senate rejected this proposal, and it was not included in the final bill that became the Future Trading Act in August 1921 (the “1921 Act”).

Shortly after its enactment, the 1921 Act was successfully challenged by members of the Chicago Board of Trade when the Supreme Court, in Hill v. Wallace, declared the imposition of speculative position limits unconstitutional as an improper use by Congress of its taxation power. However, Chief Justice Taft’s opinion suggested that such legislation might pass constitutional muster under the interstate commerce clause.

2.4 Grain Futures Act of 1922

To remedy the constitutional defects of 1921 Act, Congress enacted the Grain Futures Act of 1922 (the “Grain Act”). The Grain Act was nearly identical to the 1921 Act, but was based upon the Constitutional commerce clause rather than Congressional taxation power. In Section 3 of the Grain Act, Congress found that “sudden or unreasonable fluctuations” in the price of grain futures that “frequently occur as a result of speculation, manipulation, or control” are “an obstruction to and a burden on interstate commerce,” and thereby “render regulation imperative . . . in the national public interest.” Like its unconstitutional predecessor, however, the Grain Act did not provide the Federal Government with any authority to impose limits on trading.

2.5 Congressional Debates and Studies, 1920s and 1930s

The debate over position limits continued throughout the 1920s and into the 1930s. Senator Capper, one of the original sponsors of the 1921 Act, introduced bills in each of the Congresses from 1925-1931 to amend the Grain Act to impose limits on the positions that could be held by a single trader.

11Id.


13Hill v. Wallace, 219 U.S. at 69. Chief Justice Taft’s opinion stated: “[S]ales for future delivery on the Board of Trade are not in and of themselves interstate commerce. They cannot come within the regulatory power of Congress as such, unless they are regarded by Congress, from the evidence before it, as directly interfering with interstate commerce so as to be an obstruction or a burden thereon.”

14Dan M. Berkovitz, supra note 5; See also Grain Futures Act of 1922 § 3, Pub. L. 67-331, 42 Stat. 998 (1922).

15Id. The Grain Futures Act (the “Grain Act”) required all grain futures contracts to be traded on a designated contract market, and set forth the conditions that the Secretary of Agriculture had to find were met in order to designate a board of trade as a contract market. Designation as a contract market was contingent upon a board of trade’s providing for the prevention of manipulative activity and the prevention of dissemination of false information, upon providing for certain types of recordkeeping and for admission into exchange membership of cooperative producer associations, and upon location of the contract market at a terminal cash market. The Grain Act authorized a Commodity Exchange Commission (“CEC”), consisting of the Secretary of Agriculture, the Secretary of Commerce, and the Attorney General, to revoke the designation of any board of trade that failed to comply with these conditions.

16Id.
In 1926, as part of its comprehensive multi-year study of the grain markets, the Federal Trade Commission ("FTC") concluded in its Report on the Grain Trade, Vol. VII, Effects of Future Trading (the "FTC Report"):

That a very large trader, by himself, may cause significant fluctuations in the market. Whether he is more often right than wrong and more often successful than unsuccessful, and whether influenced by a desire to manipulate or not, if he is large enough he can cause disturbances in the market which impair its proper functioning and are harmful to producers and consumers.\(^{17}\)

The FTC recommended that limits be placed on trading, particularly on the amount of open interest that could be held by any one trader.\(^{18}\)

The Department of Agriculture also argued for Congress to provide the Grain Futures Administration (“GFA”), which had been created by the Grain Act, with the authority to impose position limits, presenting reports that discussed the difference between manipulative transactions and excessive speculation (the “GFA Report”).\(^{19}\) One study in the GFA Report, showing that trades in excess of two million bushels of wheat caused “wide and erratic” price fluctuations.\(^{20}\) This study later became the basis for a number of proposals to establish a position limit of two million bushels, which eventually became the position limit for wheat that was established under the Commodity Exchange Act of 1936. This is important because both the FTC Report and the GFA Report recommended that limits on trading be imposed to prevent large speculative positions regardless of the trader’s intent.

\[\text{2.6 Commodity Exchange Act of 1936 ("CEA")}\]

The stock market crash that began in 1929, the Great Depression, and the election in 1932 of Franklin Roosevelt as President brought new momentum to the efforts to impose speculative


\(^{18}\)Id. (The FTC stressed, “Limitation of the individual open interest is the most important point.” Id. The FTC also identified the need to exempt hedgers from the limits: “Any proposed limitation of the size of the open interest, of course, does not apply to hedges. As regards quantity, hedges are self-limiting.” The FTC also recommended reporting of large trades and the daily publication by the exchanges of volume and open interest.)

\(^{19}\)See Dan M. Berkovitz, General Counsel of the Commodity Futures Trading Comm’n, Testimony: Position Limits and the Hedge Exemption, Brief Legislative History (Jul. 28, 2009) (transcript available at www.cftc.gov); citing U.S. Grain Futures Admin., Fluctuations in Wheat Futures, S. Doc. No. 69-135 (1926). In this study of the fluctuations in wheat prices during the early part of 1925, the GFA found that five large traders, each of whom were trading more than two million bushels of grain, were responsible for “wide and erratic price fluctuations” in the wheat futures market. Although the GFA’s report emphasized the investigation “did not reveal any concentrated action for the deliberate purpose of manipulating the market,” it stated that most of the wide and erratic price fluctuations “were largely artificial and were caused primarily, either directly or indirectly, by heavy trading on the part of a limited number of professional speculators.” In the letter of transmittal to the Senate, the Secretary of Agriculture and the Chief of the GFA reported that the harmful effect that these five large traders had on grain prices demonstrated the “the need for the development of some plan of limiting excessive speculative transactions.”.

\(^{20}\)Id.
position limits on the trading of commodities. In 1934, President Roosevelt sent a formal letter to Congress recommending the regulation of the securities and commodities markets to protect investors, safeguard values, and prevent destructive speculation. In this letter President Roosevelt recommends that Congress enact legislation to allow the Federal Government to regulate and operate the securities and commodities exchanges for the protection of investors and for the elimination of unnecessary, unwise, and destructive speculation.

In response, Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934. Although Congress considered enacting legislation to strengthen the regulation of the commodities markets, including the imposition of position limits, it did not and the debate continued.

However, by the mid-1930s the tide of opinion had turned. In addition to the depression in farm prices, the inability of the exchanges and federal authorities to challenge the activities of a few prominent large traders fueled the reform movement, and Congress finally provided a federal regulatory authority with the mandate and authority to establish and enforce limits on speculative trading. In Section 4a of the CEA, Congress found that excessive speculation in the commodity futures markets created an “undue and unnecessary burden” on interstate commerce and directed

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21 Dan M. Berkovitz, supra note 5. (Quoted statements of President Roosevelt in 1934, “It is my belief that exchanges for dealing in securities and commodities are necessary and of definite value to our commercial and agricultural life. Nevertheless, it should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations.” Another Step to Protect Investors and to Eliminate Destructive Speculation – Recommendation for the Securities Exchange Commission, 3 Pub. Papers 91 (February 9, 1934)).

22 See Id. (References are made to a Report of the House Committee on Interstate and Foreign Commerce, Securities Exchange Bill of 1934, H.R. Rep. No. 73-1383, at 1-2 (1934). The Congressional findings in the Securities Exchange Act of 1934 and the Commodity Exchange Act of 1936 were very similar; both were modeled after the findings in Section 3 of the Grain Futures Act. In Section 2 of the Securities Exchange Act the Congress found that the prices of securities “are subject to manipulation and control, and the dissemination of such prices gives rise to excessive speculation.” It also found: National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit.); See also Securities Exchange Act of 1934, 15 U.S.C. § 78(b) (2018).

23 See Dan M. Berkovitz, supra note 5. (In which the testimony describes, perhaps, the most notorious large trader during the 1930s as Arthur Cutten (“Cutten”). To avoid the GFA’s requirement to report positions in excess of 500,000 bushels of grain, Cutten established 32 separate accounts, with seven different firms, in the names of friends and relatives, in amounts up to a maximum of 495,000 bushels. On a number of occasions Cutten bought or sold several million bushels of wheat; at one point Cutten held a short position of about 7 million bushels. In 1932, Cutten wrote, “The notion that I could buy or sell not more than 500,000 bushels without having my trades subjected to the scrutiny of government clerks was to me galling beyond my powers of expression.” Ferris at 192. Cutten’s victory in the Supreme Court, rejecting the GFA’s attempt to bring an after-the-fact criminal prosecution against Cutten for manipulation, Wallace v. Cutten, 298 U.S. 229 (1936), spurred Congress to include a strengthened anti-manipulation provision in the Commodity Exchange Act so as to allow prosecutions for manipulation or attempted manipulation even after they have occurred.)
the Commodity Exchange Commission ("CEC") to establish such limits on trading “as the [CEC] finds is necessary to diminish, eliminate, or prevent” such burdens.24

For the purpose of diminishing, eliminating, or preventing such burden, the CEC was to fix limits on the amount of trading under contracts of sale of such commodity for future delivery on or subject to the rules of any contract market which may be done by any person as the commission finds is necessary to diminish, eliminate, or prevent such burden.25

Congress exempted “bona fide hedging transactions” from any such limits. Congress statutorily defined a bona fide hedging transaction as sales or purchases of futures contracts that were offset by purchases or sales of the same cash commodity.26

2.7 Implementation of CEA

The CEC held hearings and in December 1938 promulgated both position limits and trading limits for grains—at the time the definition of “grain” included wheat, corn, oats, barley, flaxseed, grain sorghums, and rye.27 The CEC imposed a “position limit” of two million bushels for any single grain futures contract, as well as for “all futures combined” for any one grain. At the same time, it imposed a “daily trading limit” of two million bushels on the amount of grain that any person could buy or sell in any one business day.28


25See Id.

26Id. at § 4a(3). § 4a(3) provided:

(3) No order issued under paragraph (1) of this section shall apply to transactions which are shown to be bona fide hedging transactions. For the purposes of this paragraph, bona fide hedging transactions shall mean sales of any commodity for future delivery on or subject to the rules of any board of trade to the extent that such sales are offset in quantity by the ownership or purchase of the same cash commodity or, conversely, purchases of any commodity for future delivery on or subject to the rules of any board of trade to the extent that such purchases are offset by sales of the same cash commodity. There shall be included in the amount of any commodity which may be hedged by any person –

(A) the amount of such commodity such person is raising, or in good faith intends or expects to raise, within the next twelve months, on land (in the United States or its Territories) which such person owns or leases;

(B) an amount of such commodity the sale of which for future delivery would be a reasonable hedge against the products or byproducts of such commodity owned or purchased by such person, or the purchase of which for future delivery would be a reasonable hedge against the sale of any product or byproduct of such commodity by such person.


28Id. The CEC’s new regulation established higher position limits and trading limits for “spreading in the same grain between markets.” The position limit for spread positions read as follows:
The CEC established a federal position limit for cotton in August of 1940, and for soybeans in August of 1951. The CEC also established limits for fats and oils, including soybean oil, in April of 1953, but later suspended the enforcement of those limits and subsequently revoked them in May of 1968. The CEC also established speculative limits on lard, onions, eggs, and potatoes.\textsuperscript{29}

The establishment of position limits for these commodities under the CEA did not require the CEC to find that an undue burden on interstate commerce had actually occurred in order to establish position limits, and the CEC did not make any such findings as it implemented the statute. Rather, the statute enabled the CEC to establish position limits based upon its reasonable judgment that such limits were necessary to “diminish, eliminate, or prevent” the burdens on interstate commerce resulting from excessive speculation. Accordingly, the CEC imposed position limits on commodities without finding that an undue burden on interstate commerce had actually occurred.

The CEC never established position limits for many of the agricultural commodities subject to its jurisdiction, such as butter, wool, wool tops, livestock, and livestock products. The Chicago Mercantile Exchange (“CME”) began trading pork belly futures in 1961, live cattle futures in 1964, and live hog futures in 1966, all of which were not subject to CEA regulation. Even though not regulated, the CME, acting under its own authority, established speculative limits for trading in those contracts. The existence of these exchange-set speculative limits helps explain why the CEC and the CFTC never set federal speculative limits for trading in livestock futures, and sets the stage for the exchange-set limits that would emerge in the 1980s.\textsuperscript{30}

\section*{2.8 1968 Amendments}

The Salad Oil debacle of 1963 exposed ambiguity in the authority of CEC to enforce its position limits.\textsuperscript{31} The 1936 provision spoke in terms of trading, not positions. In 1968, Congress

\begin{quote}
To the extent that the net position held or controlled by any one person in all futures combined in any one grain or any one contract market is shown to represent spreading in the same grain between markets, the limit on net position in all futures combined set forth in paragraph 1 hereof [relating to position limits] may be exceeded on such contract market, but in no case shall the excess result in a net position of more than 3,000,000 bushels in all futures combined nor more than 2,000,000 bushels in any one future.
\end{quote}

The daily trading limit for spread trading was very similar.

\textsuperscript{29}Dan M. Berkovitz, \textit{supra} note 5.

\textsuperscript{30}At the time the CFTC began operating in 1975, “various contract markets [had] voluntarily placed speculative position limits on 23 contracts involving 17 commodities.” 45 Fed. Reg. 79831 (Dec. 2, 1980).

\textsuperscript{31}Dan M. Berkovitz, \textit{supra} note 5. (In the Salad Oil scandal, Anthony DeAngelis (“DeAngelis”) attempted to corner the soybean market, among other fraudulent activities. At one point, DeAngelis accounted for three quarters of the nation’s exports of soybean and cottonseed oil. As part of his scheme, DeAngelis filled tankers with water and topped off the tanks with soybean and cottonseed oil, falsely representing as collateral for loans that the tankers were filled with vegetable oil. Numerous lawsuits ensued once the fraud was discovered and about 16 firms were bankrupted by the scandal. \textit{The Man Who Fooled Everybody}, Time, June 4, 1965.).
responded by clarifying the law and amending the second and third sentences of Section 4a(1) to clarify the CEA’s authority to enforce position limits in addition to daily trading limits.32

2.9 1974 Amendments

In 1974, Congress overhauled the CEA to remove the regulation of the futures markets from the Department of Agriculture and created the CFTC as an independent regulatory agency.33 Additionally, it expanded the CFTC’s regulatory authority to include futures contracts in any commodity, not just the enumerated agricultural commodities.34 At the same time as it expanded the scope of the CFTC’s authority, it reiterated the purpose of the Act: to prevent fraud and manipulation and to control speculation.35

After deciding to retain the position limits for agricultural commodities previously established by the CEC, one of the first steps for the CFTC to exercise its new is to determine how to established position limits for these additional futures contracts. In August 1975, the CFTC initiated an advisory committee program to advise it on how it should perform its duties in view of the recent amendments to the CEA. As part of this advisory program, the CFTC formed an Advisory Committee on the Economic Role of Contract Markets, which held several joint public hearings on the issues of speculative trading, the definition of hedging, and delivery points. The Advisory Committee found that speculative position limits were of limited usefulness, and recommended they be “supplanted by an improved monitoring and surveillance program designed to achieve orderly liquidation of expiring contract months (the “Advisory Committee Study”).”36

In 1977, following its own study of the issue, the CFTC’s Office of the Chief Economist (“OCE”) arrived at different conclusions and recommendations (the “OCE Study”). The OCE Study found that, “Other things equal, sufficiently large positions and trades can become a perceptible market factor.”37 It therefore recommended position limits in those markets “where the characteristics of the commodity, its marketing system, and the contract lend themselves to undue influence from large speculative positions,” and that the purpose of such limits would be


34See Id.

35S. Rep. No. 93-1131 (1974). (A fundamental purpose of the Commodity Exchange Act is to insure fair practice and honest dealing on the commodity exchanges and to provide a measure of control over those forms of speculative activity which too often demoralize markets to the injury of producers and consumers and the exchanges themselves.).


to “curtail extraordinary speculative positions which are not offset by comparable commercial positions.”

2.10 Exchange-Set Limits

Despite the findings in the OCE Study, the CFTC, following the Advisory Committee Study, repealed all daily trading limits in 1979. One year later, however, after the manipulation of the silver market by the Hunt brothers, the CFTC sent out a Notice of Proposed Rulemaking (“NOPR”), requiring exchanges to set position limits for all futures contracts not subject to Commission-imposed limits, the CFTC articulated the need for and purpose of position limits.

In the NOPR, the CFTC sets out its belief that a trader’s net position has a continued effect on price, and if sufficiently large can become a perceptible market factor. In this context, the CFTC observes that speculative position limits serve to decrease the potential for positions to influence the general price level. Moreover, by limiting the ability of one person or group of persons to obtain extraordinarily large positions, speculative limits diminish the possibility of accentuating price swings if large positions must be liquidated sharply in the face of adverse price movements or for other reasons.

In promulgating the final rule, the CFTC reiterated the findings in the NOPR that position limits are needed to prevent large and/or abrupt price movements which are attributable to extraordinarily large speculative positions. Further, it is the Commission’s view that this objective is enhanced by speculative position limits since it appears that the capacity of any contract market to absorb the establishment and liquidation of large speculative positions in an orderly manner is related to the relative size of such positions, i.e., the capacity of the market is not unlimited.

In this rulemaking, the CFTC adopted Rule 1.61 (now Rule 150.5), which required exchanges to have position limits for all commodities that did not have CFTC-set limits.

In 1982, Congress ratified the CFTC’s regulatory policy by enacting Section 4a(e), which stated that nothing in the CEA prohibited the exchanges from establishing positions limits themselves, provided that such limits are not higher than any limits the Commission may have established.

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38 Dan M. Berkovitz, supra note 5.
40 Dan M. Berkovitz, supra note 5.
42 Id.
43 Id.
2.11 Position Accountability

In January 1992, the CFTC approved the CME’s request for an exemption from the requirement to establish position limits for all commodities and instead permitted the CME to establish “position accountability” for certain financial contracts traded on the CME.\(^45\) Position accountability permitted exchanges to substitute accountability levels for static position limits for both futures and options on futures contracts.\(^46\)

The CFTC would review requests from exchanges for exemptions from implementing position limit rules and initially stated that the exemption granting the position accountability program would apply to three categories of financial instruments: (1) futures contracts on foreign currencies and options thereon; (2) futures contracts and options thereon on “certain financial instruments which exhibit the highest degree of liquidity in both the futures and cash markets,” and (3) financial instruments “having a highly liquid futures or cash market, but not of the same magnitude as those in the highest class.”\(^47\) For futures contracts and options on financial instruments that exhibit the highest degree of liquidity in both the futures and cash markets, and which are readily arbitraged, the CFTC required that any exemption deleting an absolute position limit should include a level that would trigger distinct reporting requirements by a trader at the request of the applicable exchange. Additionally, for contract markets on financial instruments having a highly liquid futures or cash market, but not of the same magnitude as those in the highest class, the CFTC permitted exemptions from the absolute, fixed position limits but suggested that the exchanges include, in addition to the specified reporting requirement trigger, a rule providing for the automatic consent of the trader, when so ordered by the exchange acting in its discretion, not to increase further those positions which exceed the triggering level.

Subsequently, CFTC determined it would grant additional exemptions from the requirement to establish static position limits for energy commodity contracts. Instead, requiring exchanges to implement position accountability rules for energy commodity contracts.\(^48\) Further, the CFTC granted an exemption permitting exchanges to implement position accountability rules rather than position limit rules for positions in non-spot months. The CFTC implemented standards to be met in the exchange rules in order to take advantage of these exemptions, including reporting requirements at specified triggering levels and the authority to require a trader whose position

\(^{44}\) U.S.C. § 6a(e) (2008). The CFTC has continued to apply regulatory requirements and provide guidance for the exchanges on exchange-set position limits. In 1992, the CFTC required position limits to be adjusted to reflect increases in the size of a contract’s open interest. The 1992 formula has generally been incorporated into the CFTC’s regulations in 17 C.F.R. 150.5(c) (2009).

\(^{45}\) See 56 Fed. Reg. 51687 (Oct. 15, 1991) (Notice of proposed exchange rule changes; request for comments).

\(^{46}\) See Id. (CFTC accepted the position accountability methodology on three-month Eurodollars and several foreign currencies, citing that the continued growth in the depth and liquidity of futures and option contracts on foreign currencies and in certain financial futures or options contracts, called into question the need for position limits, as traditionally structured, in those markets.)

\(^{47}\) See Speculative Position Limits—Exemptions from Commission Rule 1.61, 57 F.R. 29064 (June 30, 1992).

\(^{48}\) Dan M. Berkovitz, supra note 5.
exceeds the triggering level to halt further increases in the position. The CFTC also stated that, for physical commodities, this exemption from position limits would be appropriate only for the deferred trading months, and spot-month limits would continue to apply.

In 1999, the CFTC formally recognized the practice of accountability by promulgating a rule that specifically allowed exchanges to establish position accountability levels, under certain conditions, rather than continue to permit position accountability through the exemptive process. The 1999 rule allowed exchanges to submit a position accountability rule rather than a position limit in circumstances in which a contract had been listed for trading for at least 12 months and met certain open interest and volume thresholds. The rule also provided that the exchanges could not use position accountability levels for the spot month; requiring exchanges to set position limits for spot-months at a level no greater than one-quarter of the estimated spot month deliverable supply.

2.12 Commodity Futures Modernization Act of 2000 (CFMA)

In the Commodity Futures Modernization Act of 2000 (“CFMA”), the Congress expressly authorized the use of position accountability as an alternative means to limit speculative positions. Among the “core principles” enacted as part of the CFMA, Designated Core Principle 5 addresses position limitations and accountability: “To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary and appropriate.”

Pursuant to the CFMA, the CFTC adopted its Part 38 regulations to apply the new core principle regime to designated contract markets. In Appendix B to its Part 38 regulations, the CFTC provided guidance as to “acceptable practices” for the exchanges to be in compliance with the various core principles. With regards to position limits and accountability, the CFTC guides the exchanges to adopt rules that diminish potential problems that may arise from excessively large speculative positions and to facilitate orderly liquidation of expiring futures contracts.

The guidance provides that spot-month limits should be adopted for markets based on commodities having more limited deliverable supplies or where otherwise necessary to minimize the susceptibility of the market to manipulation or price distortion. The guidance also allows exchanges to provide for position accountability rather than position limits “for contracts on financial instruments, intangible commodities, or certain tangible commodities. Contracts appropriate for position accountability rules include those with large open-interest, high daily trading volumes and liquid cash markets.”

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49 17 C.F.R. 150.5(e) (2009).

50 See Id.


53 See Id.
not to provide all-months-combined and non-spot individual month limits.\textsuperscript{54} It is noted under Part 38, that the existing provisions governing the establishment of exchange-set speculative position limits contained in Rule 150.5 could continue to serve as acceptable practices.

The CFMA also amended Section 3 of the CEA so to remove the language pertaining to the burdens on interstate commerce that arise from manipulation, excessive speculation and control that originally had been included in the Grain Act. The CFMA did not alter, however, the CFTC’s mandate in Section 4a to establish position limits as it finds are necessary to prevent such undue burdens on interstate commerce. Hence, although the CFMA did not include in the core principles an explicit direction that the exchanges must apply position limits or accountability as necessary to prevent the undue burdens of excessive speculation, at the same time it retained the CFTC’s explicit responsibility to establish such limits.

\textbf{2.13 CFTC Reauthorization Act of 2008}

The CFTC Reauthorization Act of 2008 contained two provisions regarding speculative limits. It amended CEA Section 4a(e) to give the CFTC enforcement authority over rules certified by exchanges. It also added core principle language regarding position limitations and accountability for derivatives transaction execution facilities.\textsuperscript{55}

\textbf{2.14 Legislative History of the Bona Fide Hedge Exemption}

\textsuperscript{54}The Part 38 “Acceptable Practices” for Core Principle 5 states, in part:

(1) In order to diminish potential problems arising from excessively large speculative positions, and to facilitate orderly liquidation of expiring futures contracts, markets may need to set limits on traders’ positions in certain commodities. . . .

(2) Provisions concerning speculative position limits are set forth in part 150. In general, position limits are not necessary for markets where the threat of excessive speculation or manipulation is nonexistent or low. Thus, contract markets do not need to adopt speculative position limits for futures markets on major foreign currencies, contracts based on certain financial instruments having very liquid and deep underlying cash markets, and contracts specifying cash settlement where the potential for distortion of such price is negligible. . . .

(3) A contract market may provide for position accountability provisions in lieu of position limits for contracts on financial instruments, intangible commodities, or certain tangible commodities. Markets appropriate for position accountability rules include those with large open interest, high daily trading volumes and liquid cash markets.

(4) Spot-month limits should be adopted for markets based on commodities having more limited deliverable supplies or where otherwise necessary to minimize the susceptibility of the market to manipulation or price distortions. The level of the spot limit for physical-delivery markets should be based upon an analysis of deliverable supplies and the history of spot-month liquidations. Spot-month limits for physical-delivery markets are appropriately set at no more than 25 percent of the estimated deliverable supply. . . . Markets may elect not to provide all months-combined and non-spot month limits.


\textsuperscript{55}See 7 U.S.C. § 6(a) (2009).
2.14.1 **Introduction**

In its enactment of the CEA in 1936, Congress made it clear that position limits should not apply to the legitimate use of the futures markets by commodity producers, merchants, or end-users to price their goods efficiently or to manage their price risks. In 1936, the language provided in section 4a of the CEA provided for a bona fide hedge exemption that narrowly defined the definition of a bona fide hedge to those sales and purchases of futures contracts made to offset the purchases and sales of the same physical commodity.

2.14.2 **Legislative and Regulatory Developments: 1956-1974**

By the mid-1950s, there was discussion that statutory bona fide hedge exemption criteria was too restrictive. In 1956, Congress responded by permitting anticipatory hedging. Congress acted again when in the early 1970s when concerns were raised, yet again, that speculative limit exemptions continued to be too restrictive by enacting the Commodity Futures Trading Act of 1974 (the **“1974 Act”**).\(^{56}\) First, Congress expanded the CFTC’s exemption authority by directing the CFTC to treat arbitrage in the same manner as “spreads” or “straddles”. Second, because the definition of commodity under the CEA was expanded by the 1974 Act beyond agricultural commodities, Congress was concerned that statutory definition failed to take into account the risk-mitigating transactions that were emerging at that time. Accordingly, Section 4a(3) of the CEA was repealed, and the CFTC was given broad administrative authority to define the type of activity that constituted bona fide hedging, subject only to the conditions that any such definition be “consistent with the purposes of the Act” and that “such terms may be defined to permit producers, purchasers, sellers, middlemen, and users of a commodity or a product derived therefrom to hedge their legitimate anticipated business needs . . . .”\(^{57}\)

In 1977, the CFTC fashioned a definition of hedging and a process for granting hedge exemptions that remained in place until the implementation of Dodd-Frank. Such definition is found in Rule 1.3(z) of the Commission’s regulations.\(^{58}\)

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\(^{58}\)In 1977, this rule was written in three parts. First is a general description of transactions or positions which the CFTC considered to be bona fide hedging under economically appropriate circumstances, and specified that no transaction or position shall be classified as bona fide hedging for purposes of exceeding federal speculative limits unless, among other requirements, it can be established and liquidated in an orderly manner. The first part stated that an entity may hedge inventory or fixed price sales or purchases without prior approval of the Commission, but must file monthly reports with the agency for positions in excess of the position limits.

The second part, “Enumerated Hedging Transactions,” specified one of the two other types of transactions that may qualify for the exemption, but that require prior Commission approval. Section 1.3(z)(2) stated that a bona fide hedge exemption may be granted for purchases or sales for future delivery of unsold anticipated production or unfilled anticipated requirements. The various types of such anticipatory hedges were “enumerated” in this subsection.
2.14.3 Futures Trading Act of 1986

By the early-1980s, new questions concerning the CFTC’s hedge exemption standards emerged and the House Agriculture Committee (the “Committee”) urged the CFTC to consider expanding the hedge exemption to include financial firms using the futures markets to manage various types of financial risks (the “House Agriculture Report”). In a similar report to the Senate, it was argued that the then-current definition of a bona fide hedge transaction “may not cover certain important new uses of financial futures and options by institutional investors.” The report urged the Commission to review its practices to ensure they were “consistent with the legitimate needs and practices of the industry.” Ultimately, however, the Committee determined that statutory changes were not necessary, claiming that the CEA granted the CFTC the necessary authority to make any needed revisions to the hedging definition. The only limit section 4a(3) places [on] the CFTC’s power to define hedging is that the definition must be consistent with the purposes of the CEA. In this context, a principal purpose of the Act, as set forth in section 4a(1), is that of preventing excessive speculation which causes sudden or unreasonable fluctuations or unwarranted changes in commodity prices.

Until 2010, there have been no further changes to the statutory provisions regarding bona fide hedge exemptions.

2.14.4 Application of Bona Fide Hedge Exemption to Risk Management Activities

In 1987, the CFTC issued a statement clarifying its interpretation of its bona fide hedging rule. The CFTC stated that various users and potential users of financial futures had expressed concern that the link to transactions in the physical commodity markets is overly restrictive and precludes the classification as hedging of numerous strategies that are otherwise risk reduc[ing]. The CFTC explained that the definition should not be construed to apply only to firms using futures contracts to reduce their exposure to risks in the cash market. It stated that the

The third part of the definition—the “non-enumerated” cases—provided that for purposes of exemptions from federal speculative limits the CFTC may recognize as bona fide hedging purchases or sales other than those enumerated in the second part of the definition. This was intended to avoid the very type of inflexibility that Congress sought to avoid by deleting CEA §4a(3) and giving the CFTC regulatory authority. It required persons requesting permission to classify transactions as hedging to provide the CFTC with evidence that such transactions met the requirements of the general definition in Regulation 1.3(z)(1) and permitted the CFTC to specify any conditions it deems necessary to assure the positions are consistent with orderly markets and other requirements of the CEA.

17 C.F.R. § 1.3(z) (2009).


61Id., at p. 22.

Commission’s original intent in promulgating the definition of a bona fide hedge was to provide a general definition to describe the broad scope of risk-shifting transactions that may be possible in the diverse types of futures contracts now under regulation. The CFTC concluded that to qualify as a bona fide hedge, a transaction in the futures market did not need to be a temporary substitute for a later transaction in the cash market, but also included all balance sheet and other trading strategies that are risk reducing and otherwise consistent with this interpretation.

Several months later, the CFTC issued a new interpretation of its definition of bona fide hedge transactions to allow exchanges to grant hedge exemptions for various risk management transactions. The CFTC adopted this new interpretation so that futures and/or options positions entered into for risk-mitigation purposes would be exempt from the exchange speculative position limits. The CFTC specified that such exemptions be granted on a case-by-case basis, subject to a demonstrated request and showing by the applicant of the need for the exemption. To obtain the bona fide hedge exemption market participants are required to apply to the exchange. The exchanges are required to monitor the exemptions to be sure that granting of such exemptions does not result in large futures and/or options positions that could potentially disrupt the futures market.63

In 1991 the CFTC began granting bona fide hedge exemptions to swap dealers seeking to manage price risk on their books as a result of swaps transactions. These exemptions have been subject to specific conditions to protect the market, including: (1) the futures positions must offset specific price risk; (2) the dollar value of the futures positions must be no greater than the dollar value of the underlying risk; and (3) the futures positions must not be carried into the spot month.

In November 2007, the CFTC proposed to amend its regulations to create a new type of exemption from the standard position limits called a “risk management exemption”.64 The risk management exemption would allow exchange traded fund managers to exceed established position limits, rather than have to continue to rely upon no-action letters. The proposed risk management exemption would have allowed an exemption from position limits for: (1) intermediaries, such as index funds, who pass price risks on to their customers; and (2) pension funds and other institutional investors seeking to diversify risks in portfolios by including an allocation to commodity exposure. This proposed rulemaking was withdrawn in 2008.65

In September 2008, the CFTC released a Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations, which included several preliminary recommendations. One recommendation directed the CFTC staff to develop an advance notice of proposed rulemaking to review whether to eliminate the bona fide hedge exemption for swap dealers and replace it with a limited risk management exemption that is conditioned upon, among


other things, an obligation to report to the CFTC and applicable self-regulatory organizations when certain noncommercial swap clients reach a certain position level and/or a certification that none of a swap dealer’s noncommercial swap clients exceed specified position limits in related exchange-regulated commodities. In March 2009, the CFTC published a release on whether to eliminate the bona fide hedge exemption for certain swap dealers and create a new limited risk management exemption from position limits. Additionally, in August of that same year, the CFTC rescinded the no-action letter it had provided to two institutional investors with relief from the federal agricultural speculative positions limits.

3. Dodd-Frank

Dodd-Frank required the CFTC to establish federal speculative position limits for futures and options contracts traded both previously “exempt commodities” (including energy and metals products) and “agricultural commodities” (which would include the agricultural products for which the CFTC has historically set position limits, as well as an expanded range of agricultural and “soft” commodities). Additionally, Dodd-Frank required the CFTC to establish aggregate position limits for other derivatives on such commodities, such as: (1) swaps that are traded on Designated Contract Markets (“DCM”) or Swap Execution Facilities (“SEF”); (2) swaps that are economically equivalent to DCM-traded futures or options contracts that are subject to position limits; (3) swaps not traded on a DCM or SEF, but which are determined to perform or affect a “significant price discovery function”; and (4) foreign board of trade (“FBOT”) contracts that are price-linked to a DCM or SEF contract and made available via direct access from within the U.S.

3.1 CFTC Proposed Amendments to Speculative Position Limits – January 2011

3.1.1 Introduction

In the CFTC proposed rules on position limits in 2011 (the “CFTC 2011 Proposed Rules”), the CFTC proposed to establish position limits for certain physical commodity derivatives, by setting limits and creating limit formulas for certain physical commodity futures and options contracts executed on DCMs and physical commodity swaps that are economically equivalent to such DCM contracts. Additionally, the CFTC proposed aggregate position limits that would

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67 See DB Commodity Services, LLC, CFTC No-Action Letter No. 06-09 (May 5, 2006); CFTC No-Action Letter No. 06-19 (Sept. 6, 2006).

68 15 U.S.C. § 8307(a); See also 124 Stat. 1715, Section (f) Core Principles for Swap Execution Facilities, (6) Position Limits or Accountability.

69 124 Stat. 1715, Section 735 Designated Contract Markets, subsection (5) POSITION LIMITATIONS OR ACCOUNTABILITY; SEC. 737. POSITION LIMITS; SEC. 738. FOREIGN BOARDS OF TRADE.


71 Id.
apply across different trading venues to contracts based on the same underlying commodity.\textsuperscript{72}

The CFTC proposed to establish position limits in two phases: (1) the first phase would involve adopting current DCM spot month limits while (2) the second phase would involve establishing non-spot month limits based on open interest levels.\textsuperscript{73} The CFTC 2011 Proposed rules also contained an exemption for bona fide hedging transactions and for positions that are established in good faith prior to the effective date of the final position limit rules.\textsuperscript{74} The CFTC 2011 Proposed Rules also established requirements and standards for position limits and accountability rules.\textsuperscript{75}

### 3.1.2 Definitions

The CFTC proposed a definition to identify the spot-month for referenced contracts in the same commodity that would be subject to the proposed position limit framework. The spot month definitions referenced the dates on which the spot-month would commence and end, depending upon the then existing DCM spot-month definition provided for such core referenced futures contract.\textsuperscript{76} These spot-month periods for such core referenced futures contracts would then apply to all referenced contracts in the same commodity.\textsuperscript{77}

In the CFTC 2011 Proposed Rules, the CFTC identified twenty-eight “core” physical delivery futures contracts (“\textit{Core Referenced Futures Contracts}”).\textsuperscript{78} Coupled with the Core Referenced Futures Contracts, the CFTC 2011 Proposed Rules also defined referenced contracts to mean option contracts, swaps, or swaptions measured on a futures equivalent basis with respect to a Core Referenced Futures Contract (“\textit{Referenced Contracts}”).\textsuperscript{79}

\begin{footnotes}
\footnote{\textsuperscript{72}Id.}
\footnote{\textsuperscript{73}Id.}
\footnote{\textsuperscript{74}Id.}
\footnote{\textsuperscript{75}Id.}
\footnote{\textsuperscript{76}17 C.F.R Part 151.3 (provides that the term “spot month” does not refer to a month of time, but rather it is the trading period immediately preceding the delivery period for a physically-delivered futures contract and cash-settled swaps and futures contracts that are linked to the physically-delivered futures contract and cash settled swaps and futures contracts that are linked to the physically-delivered contract; the length of this period may vary depending on the referenced contract.)}
\footnote{\textsuperscript{77}75 Fed. Reg. at 4757.}
\footnote{\textsuperscript{78}Id. at 4753; 17 CFR Part 151.2; \textit{See also} Katten Muchin Rosenman, LLP, Advisory, \textit{CFTC Proposes Substantial Amendments to Speculative Position}, February 2011; The core referenced futures contracts included: Chicago Board of Trade Corn, Oats, Rough Rice, Soybeans, Soybean Meal, Soybean Oil and Wheat; Chicago Mercantile Exchange Feeder Cattle, Lean Hogs, Live Cattle and Class III Milk; Commodity Exchange, Inc. Gold, Silver and Copper; ICE Futures U.S. Cocoa, Coffee C, FCOJ-A, Cotton No.2, Sugar No. 11 and Sugar No. 16; Kansas City Board of Trade Hard Winter Wheat; Minneapolis Grain Exchange Hard Red Spring Wheat; and New York Mercantile Exchange Palladium, Platinum, Light Sweet Crude Oil, New York Harbor No. 2 Heating Oil, New York Harbor Gasoline Blendstock and Henry Hub Natural Gas.}
\footnote{\textsuperscript{79}17 CFR Part 151.1.}
\end{footnotes}
3.1.3  Position Limits

For the Core Referenced Futures Contracts, the CFTC maintained the DCM-defined spot-month position limits. 80 For Referenced Contracts, the CFTC proposed position limits for physically delivered Referenced Contracts of one-quarter (or twenty-five percent (25%)) of the estimated spot-month deliverable supply for the Core Referenced Futures Contract in the same commodity. 81 For financially-settled Referenced Contracts the spot-month position limit was proposed to be five (5) times the spot-month position limit. The application of this spot-month position limit on financially-settled Reference Contracts was conditioned upon whether the trader that held: (1) a position in excess of the applicable single-month (non-spot month) position limit for such financially-settled contract; (2) any spot-month position in the corresponding physically settled contract; or (3) physical or forward commodity positions in the same commodity in the spot-month that exceeded twenty-five (25%) of the estimated deliverable supply. 82 The spot-month position limits only applied to positions in physically-delivered or financially-settled Referenced Contracts with delivery locations that match the delivery locations of the Core Referenced Futures Contract in that same commodity. 83

To initially determine deliverable supply, the CFTC relied upon the DCM’s estimate of deliverable supply. After which, the CFTC would set these spot-month limits based upon what it determines to be the deliverable supply. 84

For the non-spot month position limits, the CFTC 2011 Proposed Rules disallowed a persons to hold positions in all-months or in a single month in excess of: (1) ten percent (10%) of the first 25,000 contracts of average all-month-combined aggregate option interest, as it was calculated by the CFTC, which would increase at 2.5% thereafter (the “all-month aggregate position limit”); (2) the all month aggregate position limit for all contracts of the same class. 85 The CFTC 2011 Proposed Rules established two classes: (1) a class comprised of all futures and option contracts designated on DCMs and (2) a class of swaps. 86

To clarify, not only did the CFTC 2011 Proposed Rules propose an aggregate all-month and single-month position limit, but it also proposed an all-month and single-month position limit

80 17 CFR Part 151.2; 75 Fed. Reg. at 4757.
81 17 CFR Part 151.4.
82 75 Fed Reg. 4757; 17 CFR Part 151.4.
83 17 CFR Part 151.4.
84 17 CFR Part 151.4.
85 17 CFR Part 151.4.
86 75 Fed. Reg. at 4759.
that would apply across classes.\textsuperscript{87} Class limits were proposed to ensure that market power was concentrated in any one submarket.\textsuperscript{88}

The CFTC maintained the already existing limits on agricultural commodities equal to the then current all-month combined levels but it would increase the position limits corresponding single-month limit to equal the all-month-combined limit.\textsuperscript{89}

At this time, because the CFTC lacked sufficient data on the physical commodity derivative markets to implement the aggregate non-spot month position limits on such derivatives, the CFTC proposed a phased implementation, noting that it did not intend to adopt specific aggregate non-spot month position limits until the first quarter of 2012 (unless the CFTC determined it had sufficient data to implement certain position limits at an earlier date).\textsuperscript{90}

3.1.4 Aggregation of Accounts

The CFTC 2011 Proposed Rules established standards by which accounts were to be aggregated, specifically for positions in Referenced Contracts.\textsuperscript{91} Under the CFTC 2011 Proposed Rules that position limits for Referenced Contracts would apply to all positions in accounts in which any trader, directly or indirectly, has an ownership or equity interest of ten percent (10\%) or greater or, by power of attorney or otherwise, controls trading.\textsuperscript{92} The CFTC 2011 Proposed Rules would also treat positions held by two or more traders acting pursuant to an express or implied agreement or understanding the same as if the positions were held by, or the trading positions were done by, a single trader.\textsuperscript{93} It also required traders to aggregate positions in multiple accounts or pools, including passively managed index funds, if those accounts or pools had identical trading strategies.\textsuperscript{94} There was a limited exemption for positions in pools in which a person that is a limited partner, shareholder or similar person has ownership or equity interest of between ten percent (10\%) or twenty-five percent (25\%), if the person does not have control over or knowledge of the pools trading.\textsuperscript{95} Additionally, there was a limited exemption proposed for positions of futures commission merchants in certain discretionary accounts if they maintained only minimum control over trading in the relevant account and if the trading decisions of that account were independent from the trading decisions in the futures commission

\textsuperscript{87}Id.

\textsuperscript{88}Id.

\textsuperscript{89}17 CFR Part 151.4.

\textsuperscript{90}75 Fed. Reg. at 4759.

\textsuperscript{91}Id.

\textsuperscript{92}Id; 17 CFR Part 151.7.

\textsuperscript{93}Id.

\textsuperscript{94}Id.

\textsuperscript{95}Id.
merchant’s other accounts. There was a final limited exemption for entities to disaggregate the positions of independently controlled and managed trader that is a not a financial entity.

3.1.5 Recordkeeping and Reporting

The trader visibility requirements established levels that triggered reporting to the CFTC. The reporting requirements were established to make the physical and derivatives portfolios of the largest traders visible to the CFTC. The CFTC planned to use this information to assess the appropriateness of the position limits. Additionally, the CFTC planned to use these reports to identify where a trader’s large position could create the ability to manipulate the market and cause sudden price changes or distortions.

3.2 CFTC Proposed Amendments to Bona Fide Hedging Exemption – January 2011

The bona fide hedge exemption proposed in the CFTC 2011 Proposed Rules would apply to exempt and agricultural commodities, meaning the then current CFTC Regulation 1.3(z) would no longer apply to exempt and agricultural commodities. The bona fide hedging exemption in the CFTC 2011 Proposed Rules was substantially similar to the then current CFTC Regulation 1.3(z) with the following exemptions: (1) a position would be recognized as a bona fide hedge only if it represented a substitute for a cash market transaction and (2) the proposed rules explicitly recognize positions established to reduce the risk of a swap position as a bona fide hedge, provided that either: (a) the counterparty to such swap position qualified for a bona fide hedging transaction exemption (on a “look through” basis) or (b) the risk reducing positions offset a swap that itself qualifies as a bona fide hedging transaction.

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96 Id.
97 Id.
98 Id at 4759; 17 CFR Part 151.6.
100 Id.
101 Id.
102 Id at 4760 (note that CFTC Regulation 1.3(z) is now only applicable to excluded commodities).
103 Id.; The regulatory definition of a bona fide hedging transaction provides, in part: “transactions or positions in a contract for future delivery on any contract market or in a commodity option, where such transactions or positions normally represent a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel, and where they are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise.”; 17 C.F.R. § 1.3(z)(1) (2011); 17 CFR Part 151.5.
104 Id.
The CFTC 2011 Proposed Rules also lists enumerated hedging transactions, including unfilled anticipated requirements transactions and anticipatory hedging.\textsuperscript{105}

Additionally, the CFTC 2011 Proposed Rules proposed to establish new application, recordkeeping and reporting requirements for traders relying on the bona fide hedge exemption, requiring traders who qualify for a bona fide hedge exemption to maintain complete books and records concerning all of their related cash, futures and swaps positions and transactions, along with a list of swap counterparties.\textsuperscript{106} These records were required to be made available to the CFTC upon request.\textsuperscript{107}

### 3.3 CFTC Final Position Limit Rules – October 2011

In October 2011, the CFTC adopted Part 151 of its regulations on position limits for certain physical commodities (the “Final Rule”).\textsuperscript{108} The Final Rule was published in the Federal Register on November 17, 2011.

#### 3.3.1 Referenced Contracts Under the Final Rule

The Final Rule applied with respect to “Referenced Contracts”. If futures or swaps were not Referenced Contracts then there was no restriction under the Final Rule on the amount of futures and/or options that could be held by a trader. Under the Final Rule, a “Referenced Contract” included: (1) a Core Referenced Futures Contract\textsuperscript{109} and (2) a futures contract, options contract, swap or swaption (other than a basis contract or contract on a commodity index) that was: (a) directly or indirectly linked, including partially or fully settled on, or priced at a fixed differential to, the price of a Core Referenced Futures Contract or (b) directly or indirectly linked, including partially or fully settled on, or priced at a fixed differential to, the price of the same underlying Commodity as a Core Referenced Futures Contract for delivery at the same location or location as specified in such Core Referenced Futures Contract.

As in the CFTC 2011 Proposed Rules, the Final Rule set forth twenty-eight (28) Core Referenced Futures Contracts.\textsuperscript{110} In general, the Core Referenced Futures Contracts were futures

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{105}CFR Part 151.5.
\item \textsuperscript{106}Id.
\item \textsuperscript{107}Id.
\item \textsuperscript{108}17 C.F.R § 150 – 151 (2011).
\item \textsuperscript{109}Id. at § 151.2.
\item \textsuperscript{110}Core Referenced Futures Contracts included the following futures contracts and options thereon: (1) Core Referenced Futures Contracts in legacy agricultural commodities -CBOTCorn, CBOTOats, CBOT Soybeans, CBOT Soybean Meal, CBOT Soybean Oil, CBOT Wheat, ICE Futures U.S. Cotton No.2, KCBTHard Winter Wheat, and MGEX Hard Red Spring Wheat; (2) Core Referenced Futures Contracts in non-legacy agricultural commodities: CME Class III Milk, CME Feeder Cattle, CME Lean Hog, CME Live Cattle, CBOT Rough Rice, ICE Futures U.S. Cocoa, ICE Futures U.S. Coffee C, ICE Futures U.S. FCOJ-A, ICE Futures U.S. Sugar No.11, and ICE Futures U.S. Sugar No.16; (3) Core Referenced Futures Contracts in metal commodities: COMEX Copper, COMEX Gold, COMEX Silver, NYMEX Palladium, and NYMEX Platinum; (4) Core Referenced Futures Contracts in energy commodities:
\end{enumerate}
\end{footnotesize}
contracts traded on DCMs in certain agricultural, energy and metal commodities. Nine (9) of the Core Referenced Futures Contracts were legacy contracts that have previously been subject to federal position limits under Part 150 of the CFTC regulation. In addition, options that expire in to outright positions in Core Referenced Futures Contracts were also considered Core Referenced Futures Contracts.

Additionally, the Final Rule designated “look alike” contracts (i.e. contracts that settle off of a Core Referenced Futures Contract and a contracts that is based on the same commodity for the same delivery locations as Core Referenced Futures Contracts. It designated contracts that referenced a price that was based only on the combination of at least one Referenced Contract price and one or more prices in the same or substantially similar commodity as the underlying relevant Core Referenced Futures Contract as Referenced Contracts. It also designated intercommunity spreads with two components, one or both of which was a Referenced Contracts as a Referenced Contract.

The Final Rule did not include a category of Referenced Contract for contracts based on “substantially the same supply and demand fundamentals”, as it was written in the CFTC 2011 Proposed Rules, because the CFTC determined that this would require CFTC to conduct individualized evaluation of the trading data, which it did not possess.

Under the Final Rule, a swap would be considered a Referenced Contract if the sole floating reference price of the swap was based on the prices generated directly or indirectly from the price of a single Core Referenced Futures Contract or if the swap was priced based on a fixed differential to a Core Referenced Futures Contract. Conversely, if the swap was based on the difference in price of a commodity at a different delivery location, then the swap would be considered a basis contract and would not be subject to the position limits under the Final Rule. Also, if the swap was based on prices of multiple different commodities that made up an index, the swap would be considered a commodity index contract and not be subject to the position limits under the Final Rule. However, if the swap was based on the difference between the prices of two different commodities with one linked to a Core Referenced Futures

NYMEXHenryHubNaturalGas, NYMEXLightSweetCrudeOil, NYMEXNewYorkHarborGasolineBlendstock, and NYMEXNewYorkHarborHeatingOil.

118 Id.
Contract (and the other linked to the price of the same, or different, Core Referenced Futures Contract) then the swap was an intercommodity spread contract and not a commodity index, and therefore not subject to the limits under the Final Rule.\footnote{Id.}

### 3.3.2 Spot Month Limits Under the Final Rule

The spot-month limit for physically delivered Core Reference Futures Contracts was to be initially set at the existing DCM levels. The spot-month limit for financially settled Referenced Contracts was to be set at the same level. The Final Rule gave traders sixty (60) days from the day the CFTC defined the term “swap” to be in compliance with the spot-month limit.\footnote{17 C.F.R § 151.4 (2011).} (Note: At this point in the rule making process, the CFTC did not promulgate the rules with regards to the definition of a swap.) Until the date that the Final Rule applied, traders were to continue to be subject to the limits imposed by the DCMs with respect to the non-legacy Referenced Contracts.\footnote{76 Fed. Reg. 71632 (Nov. 18, 2011).}

The nine (9) legacy Referenced Contracts (all agricultural contracts) would be subject to the position limits that were imposed by the Final Rule.\footnote{17 C.F.R. § 151.3 (2011).}

In the second phase of implementation, the spot-month limit for physically delivered Referenced Contracts would be based upon twenty-five (25%) of the estimated deliverable supply.\footnote{See Id. at. § 151.4.} The second phase was said to start on January 1st of the second calendar year after the CFTC defined the term “swap”.\footnote{Id.} In this second phase, the spot-month position limits for agricultural commodities would be set annually and the spot-month position limit for metals and energy commodities would be set bi-annually.\footnote{76 Fed. Reg. 71631 (Nov. 18, 2011).}

For financially settled Referenced Contracts, the CFTC set interim spot-month position limits using the same methodology as physically delivered contracts, with the exception of natural gas Referenced Contracts (the Core Referenced Futures Contract to which is the NYMEX Henry Hub Natural Gas future). Financially settled natural gas contracts would have any month limit and an aggregate month limit of five (5) times the level of the physical delivery of the Core Referenced Futures Contract.\footnote{17 C.F.R § 151.4 (2011).} Once the CFTC obtained enough data on these contracts, the

\footnote{Id.}
Final Rule allowed the CFTC to implement different spot-month limits for financially settled contracts.

For financially settled Core Referenced Futures Contracts, the spot-month position limit was set to be twenty-five (25%) of deliverable supply.\textsuperscript{127}

A trader’s position in the physically-delivered Referenced Contract and the financially-settled Reference Contract were to be calculated separately, meaning netting was not permissible under the final rule as between physically-delivered Referenced Contracts and financially-settled Reference Contracts.\textsuperscript{128} A trader was permitted, however, to net its position in financially settled Referenced Contracts.\textsuperscript{129} Again the CFTC made an exception for the natural gas Referenced Contract. For the aggregate spot-month position limit in the natural gas Referenced Contract, the Trader’s positions could have been combined and the net resulting position would be used to determine the trader’s aggregate position.\textsuperscript{130}

3.3.3 Non-Spot Month Limits Under the Final Rule

For non-legacy Referenced Contract position limits, the all-month combined aggregate and single-month position limit was set by the CFTC to be 10\% of the first 25,000 contracts of all months combined aggregated open interest, which increase 2.5\% thereafter.\textsuperscript{131} These limits will be set by the CFTC within one month of the CFTC obtaining 12-months’ of open interest data.\textsuperscript{132}

For legacy Referenced Contracts (agriculture contracts) the all-month combined aggregated limit and the single month limit was provided in the Final Rule, which became effective on January 17, 2012.\textsuperscript{133}

For the purpose of applying the non-spot month position limits, a trader’s position in a Referenced Contract was permitted to be combined and the net position was the one applied toward determining the trader’s aggregate single-month and all-months-combined position.\textsuperscript{134}

3.4 CFTC Final Bona Fide Hedging Rules – October 2011

\textsuperscript{127}76 Fed. Reg. 71632 (Nov. 18, 2011).

\textsuperscript{128}Id. at 71645.

\textsuperscript{129}Id. at 71687.

\textsuperscript{130}Id.

\textsuperscript{131}17 C.F.R § 151.4(d)(1) (2011).

\textsuperscript{132}76 Fed. Reg. 71641 (Nov. 18, 2011).

\textsuperscript{133}Id. at 71642.

\textsuperscript{134}Id. at 71640.
Under the Final Rule, persons that met the definition of holding a bona fide hedge position were exempt from the position limit rules.\textsuperscript{135}

A transaction or position in a Referenced Contract would be considered a bona fide hedge if: (1) it represented a substitute for transactions made or to be made or positions to be taken at a late time in the physical market, (2) it was economically appropriate to reduce risk the risks associated with the conduct and management of a commercial enterprise and (3) it arose from the potential change in the value of: (a) assets, liabilities, services, or (b) it reduced the risks in a swap position.\textsuperscript{136}

3.4.1 Anticipatory Hedges

The Final Rule listed transactions that qualified as bona fide hedges, some of which provide for the hedging of anticipated risk.\textsuperscript{137} The Final Rule included an anticipatory merchandising hedge defined as offsetting sales and purchases in the Referenced Contract that do not exceed in quantity the amount of the same physical commodity that is anticipated to be merchandised.\textsuperscript{138}

Another was the anticipated royalty hedge which was defined as the offsetting sales and purchase in Referenced Contracts offset by the anticipated change in value from royalty rights that are owned by the same person.\textsuperscript{139}

The Final Rule listed the anticipated service hedge which was the offsetting sale and purchase in Referenced Contracts offset by the anticipated change in value of receipts of payments due or expected due under an executed contract for service held by the same person.\textsuperscript{140} It also outlined a cross-commodity hedge, which was the offsetting sale and purchase in Referenced Contracts by the quantity of the same cash commodity.\textsuperscript{141}

In the Final Rule, the CFTC deemed a pass-through swap as a bona fide hedge, which is the purchase and sales of Referenced Contracts that reduce the risks attributable to a position held in a swap that was executed opposite a counterparty for whom the swap transaction would qualify as a bona fide hedge transaction.\textsuperscript{142} The pass-through swap exemption did not apply to a series of swap transactions. The exemption only applies to the swap that was executed opposite the counterparty eligible for the bona fide hedge exemption. In order to claim the pass-through

\textsuperscript{135}17 C.F.R § 151.5 (2011).

\textsuperscript{136}Id. at § 1.3(z)(1).

\textsuperscript{137}Id. at § 5151.5(d).

\textsuperscript{138}Id.

\textsuperscript{139}Id.

\textsuperscript{140}Id.

\textsuperscript{141}Id.

\textsuperscript{142}17 C.F.R. § 151.5(a)(3) (2011).
exemption, the non-bona fide counterparty was required to obtain a representation from its counterparty at the inception, or execution, of the swap transaction and have a good-faith believe that the swap would qualify for an enumerated hedge. The Final Rule allowed for this representation to be made in the confirmation and required that such confirmation be retained for five (5) years and was subject to CFTC review upon request.\footnote{Id. at § 151.5.}

For risk reducing transactions that were not specifically listed in the Final Rule, the CFTC permitted the trader to apply to the CFTC for a determination as to whether the transaction would be considered a bona fide hedge.\footnote{Id.}

The Final Rule required that bona fide hedge positions be established and liquidated in an orderly fashion, providing for specific rules with regards to the ordering liquidation of positions held as per the enumerated anticipatory bona fide hedges.\footnote{Id. (As part of the orderly liquidation requirement, many of the enumerated hedging transactions require a trader not to maintain physical-delivery Referenced Contracts during the last five days of trading or the spot month for the related Core Referenced Futures Contracts. This limitation is imposed because of a situation, such as where a trader that does not own assets but expects to acquire assets is permitted to claim a bona fide hedging exemption with respect to such assets, but the trader does not acquire such assets contrary to expectation.)}

The Final Rule was flexible with regards to cash market risk, allowing the trader to either hedge on a one-to-one transaction bases or to combine all the risks associated with all, or some, of his portfolio, as long as the hedge is economically appropriate to reduce the risk in the conduct and management of a commercial enterprise.\footnote{17 C.F.R. § 151.5(a)(2) (2011).}

3.4.2 Form 404, Form 404A and Form 404S

The Final Rule required the trader to file Form 404 when his bona fide hedge position exceed the position limit no later than 9 am on the morning of the third business day after the position limit was exceeded.\footnote{Id. at § 151.5.} Thereafter, the trader was to file Form 404 by 9am on the third business day following each calendar month.\footnote{Id. at § 151.10.}

To claim an exemption based upon the anticipatory hedge transactions, the Final Rule required the trader to file a Form 404 at least ten (10) business days in advance of the date the transaction or position in the Referenced Contract would exceed the position limit.\footnote{Id. at § 151.10.}
A trader that anticipated that he would exceed the position limits in reliance on the pass-through hedge exemption, was required to file Form 404S within the same time period applicable to Form 404.\textsuperscript{150}

3.4.3 Aggregation

The Final Rule applied the position limits across all positions in accounts for which any person by power of attorney or otherwise directly, or indirectly, holds positions or controls trading and to positions held by two or more persons acting pursuant to an expressed, or implied, agreement or understanding that the positions would be held, or traded, as if by a single person.\textsuperscript{151}

Control is not defined under the Final Rule, but based upon a number of CFTC releases, including the 1979 Statement of Aggregation Policy\textsuperscript{152}, control existed when the trader had the authority to make trading decisions on the acquisition or liquidation of specific positions or if the trader had the authority to direct all or a portion of the trading for an account, even though others may make specific trading decisions.

Except for the ownership interest in limited partners, shareholders, members of a limited liability company, beneficiary of a trust or similar type of pool participant in a commodity pool or accounts or positions in multiple pools, any person holding positions in more than one account, or holding accounts or positions in which the person by power of attorney or otherwise directly or indirectly has a ten (10) percent or greater ownership or equity interest, must aggregate all such accounts or positions to apply the position limits established by the Final Rule.\textsuperscript{153}

The Final Rule did not adopt the proposed exemption with respect to owned non-financial entities, were would have been exempted from the aggregation if they were independently controlled and managed.

The Final Rule did not apply the aggregation requirement based on the ten (10) percent ownership or equity interest in a commodity pool as a limited partner, shareholder or other similar type of pool participant, other than certain specifically listed situations.\textsuperscript{154}

\textsuperscript{150}Id. at § 151.5.

\textsuperscript{151}Id. at § 151.7.


\textsuperscript{153}17 C.F.R. § 151.7 (2011).

\textsuperscript{154}Id. (1) 25% Test: limited partner, shareholder or other similar type of pool participant (“Pool Participant”) that owns 25% or more ownership or equity interest in a commodity pool must aggregate positions held by such commodity pool with positions held by such Pool Participant, if the operator of such commodity pool is exempt from registration under 17 C.F.R. § 4.13. (2) Ownership in a Pool and the Pool Operator: A person that is a10% or more Pool Participant and that is also a principal or affiliate of the pool must aggregate positions held by the pool with all other positions owned or controlled by such person, unless (a) the pool operator has and enforces written procedures to preclude the person from having knowledge of, gaining access to or receiving data about the trading or positions of the pool, (b) the person does not have direct, day-to-day supervisory authority or control over the pool’s trading decisions and (c) the pool operator has complied with the notice filing requirements. (3) Commodity
4. CFTC Position Limit Rules Vacated by DC District Court

4.1 Introduction

With the Final Rules due to take effect on October 12, 2012, on December 2, 2011, the International Swaps and Derivatives Association ("ISDA") and the Securities Industry and Financial Markets Association ("SIFMA") filed a challenge to the Position Limit Rules in the U.S. District Court for the District of Columbia (the "Court").\(^{155}\) On September 28, 2012, the Court vacated the Final Rules, remanding them to the CFTC.\(^{156}\)

ISDA and SIFMA argued that the CFTC misinterpreted their statutory authority under the CEA, leaving the courts to determine whether, or not, the CFTC promulgated the Final Rules based upon a correct and permissible interpretation of the CEA.\(^{157}\)

ISDA is a trade association whose membership represent “participants in the privately negotiated derivatives industry”\(^{158}\). SIFMA is an association of hundreds of securities firms, banks, and asset managers whose claimed mission is to “support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets.”\(^{159}\)

The main issue in the case was whether the Dodd-Frank amendments to Section 4a of the CEA (codified at 7 U.S.C. Section 6(a), as described above) mandated that the CFTC impose a new position limit regime in the commodity derivatives market.\(^{160}\) The Court write that was undisputed that, prior to Dodd-Frank, the CEA had given the CFTC the authority to set position limits on the futures and options contracts in the derivatives markets.\(^{161}\)

4.2 Factual Basis for the Claim

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Pool Operator that is Pool Participant: A commodity pool operator that has 10% or more ownership or equity interest as a Pool Participant in another pool must aggregate positions held by such pool with all other positions owned or controlled by such commodity pool operator.


\(^{156}\) *Id.*

\(^{157}\) *Id.* See also Linklaters, *Federal District Court Vacates the CFTC’s Position Limit Rules on Derivatives Linked to 28 Physical Commodities*, October 1, 2012.

\(^{158}\) *Int’l Swaps and Derivatives Ass’n. v. CFTC* at 261.

\(^{159}\) *Id.*

\(^{160}\) *Id.* at 162; See also 7 U.S.C. § 6(a).

\(^{161}\) *Int’l Swaps and Derivatives Ass’n. v. CFTC* at 262; See also 7 U.S.C. § 6(a) (stating that CFTC has authority to proclaim and fix position limits “from time to time” “as the Commission finds are necessary to diminish, eliminate, or prevent [excessive speculation].”).
On January 13, 2011, prior to the issuance of the CFTC 2011 Proposed Rules, the CFTC held an open meeting. At the open meeting, Commissioner Michael V. Dunn stated that, “to date CFTC staff [had] been unable to find any reliable economic analysis to support either the connection that excessive speculation is affecting the market … or that position limits will prevent excessive speculation.”

Dunn also stated that it was his “fear” that “at best position limits are a cure for a disease that does not exist, or at worst it’s a placebo for one that does.” Additionally, Commissioners Jill Sommers and Scott O’Malia express fundamental concerns with regards to the position limit proposal.

With regards to its statutory authority, in the CFTC 2011 Proposed Rules, the CFTC’s view of its statutory authority was that it was “not required to find an undue burden on interstate commerce resulting from excessive speculation … nor was it “required to make an affirmative finding that position limits [were] necessary to prevent sudden or unreasonable fluctuations or unwarranted changes in prices or otherwise necessary for market protection.” The CFTC claimed that it may impose position limits prophylactically, based on its reasonable judgement that such limits [were] necessary for the purpose of diminishing, eliminating, or preventing such burdens on interstate commerce. The CFTC stated that the “basic statutory mandate in section [6]a of the [CEA] [was] to establish position limits to prevent ‘undue burdens’ associated with ‘excessive speculation’ has remained unchanged—and has been reaffirmed by Congress several times—over the past seven decades.” The CFTC noted that “[P]ursuant to the Dodd-Frank Act, Congress significantly expanded the [CFTC’s] authority and mandate to establish position limits beyond futures and options contracts to include, for example, economically equivalent derivatives. Congress expressly directed the [CFTC] to set limits in accordance with the standards set forth in sections [6]a(a)(1) and [6]a(a)(3) of the [CFTC], thereby reaffirming the CFTC’s authority to establish position limits as it finds necessary in its discretion to address excessive speculation.”

The Final Rules were adopted in a 3 to 2 vote. Chairman Gary Gensler, Commissioner Bart Chilton and Commissioner Dunn voted in favor of the Final Rules. Despite the fact that Dunn


163 Id.


166 Id.

167 Id.

168 Id. at 4755.

169 Id. at 4754.

170 Id.
had reservations about the Final Rules, Commissioner Dunn voted in favor of the Final Rules, stating that “Position limits [were], in [his] opinion, a sideshow that had unnecessarily diverted human and fiscal resources away from actions to prevent another financial crises ... [that] Congress [had] tasked the CFTC with preventing excessive speculation by imposing position limits... [and, therefore,] the law [was] clear and [he would] follow the law.\textsuperscript{171} Commissioner Gensler supported Commissioner Dunn’s view, claiming that Congress had mandated the CFTC set aggregate position limits for certain physical commodity derivatives.\textsuperscript{172}

Commissioners Sommers and O’Malia voted against the Final rule and published written dissents.

Sommers claimed that, while she was not philosophically opposed to position limits, she did “not believe position limits will control prices or market volatility” in this market.\textsuperscript{173} Sommers argued that the Final Rule would cause great harm to bona fide hedgers and may result “in increased food and energy costs for consumers.”\textsuperscript{174} Sommers argued that the CFTC had gone beyond the authority given to them in the statute and created a “very complicated regulation that has the potential to irreparably harm these vital markets.”\textsuperscript{175}

Commissioner O’Malia claimed that, although he had a number of serious concerns about the Final Rule, his “principal disagreement is with the Commission’s restrictive interpretation of the statutory mandate under Section 4a [7 U.S.C. § 6a] of the [CEA] to establish position limits without making a determination that such limits are necessary and effective in relation to the identifiable burdens of excessive speculation on interstate commerce.”\textsuperscript{176} Commissioner O’Malia argued that “the [CFTC] ignores the fact that in the context of the Act, such discretion is broad enough to permit the Commission to not impose limits if they are not appropriate.”\textsuperscript{177} Commissioner O’Malia claimed that the CFTC had “miss[ed] an opportunity to determine and define the type and extent of speculation that is likely to cause unreasonable and/or unwarranted commodity price movements so that it can respond with rules that are reasonable and appropriate.”\textsuperscript{178} According to Commissioner O’Malia, the CFTC, historically had taken a more disciplined and fact-based approach to adoption positions limits and adopted the Final Rules

\textsuperscript{171} U.S. Commodity Futures Trading Comm’n, Transcript of Open Meeting on Two Final Rule Proposals Under the Dodd-Frank Act 11, 13 (Oct. 18, 2011).

\textsuperscript{172} See 76 Fed. Reg. 71626, 71638, 71699 (Nov. 18, 2011).

\textsuperscript{173} Id. at 71699.

\textsuperscript{174} Id.

\textsuperscript{175} Id. at 71700.

\textsuperscript{176} Id.

\textsuperscript{177} Id. at 71701.

\textsuperscript{178} Id. at 71700.
without performing any objective factual analysis as to whether, or not, these limits were
necessary to prevent excessive speculation.179

4.3 The Claims

ISDA and SIFMA claimed the Final Rules were a violation of the: (1) CEA and APA180 — Failure to Prove the Rule was Necessary and Appropriate under 7 U.S.C. Section 6a(a)(1), (a)(2)(A) and (a)(5)(A); (2) CEA -- Insufficient Evaluation of Costs and Benefits under 7 U.S.C. § 19(a)181; (3) APA -- Arbitrary and Capricious Agency Action in Promulgating the Final Rules,182 (4) APA—Arbitrary and Capricious Agency Action in Establishing Specific Position Limits and Adopting Related Requirements and Restrictions; and (5) APA—Failure to Provide Interested Persons A Sufficient Opportunity to Meaningfully Participate in the Rulemaking.183 ISDA and SIFMA sought injunctive relief.

4.4 Court Analysis

To grant injunctive relief, the Court had to decide, as a matter of law, whether or not the CFTC’s record supported the action taken and whether it was consistent with the APA standard of review.184 The standard of review was to determine whether the CFTC’s decision “was arbitrary and capricious, and whether its findings were based on substantial evidence.”185 ISDA and SIFMA argued that the CEA is clear and unambiguous and that the CFTC is required, by statute, to present a finding of necessity prior to its promulgating the Final Rule.186 ISDA and SIFMA argued that the CEA required an obligation for the CFTC to determine whether the position limits and the specific commodities to which they were tied were necessary and appropriate.187 ISDA and SIFMA claim that under Section 61(a)(1), the CFTC has discretion to establish position limits from time to time “as the Commission finds are necessary to diminish, eliminate, or prevent” the burden on interstate commerce caused by excessive speculation.188

179Id. at 71702.


183Int’l Swaps and Derivatives Ass’n. v. CFTC at 265.

184See Richards v. INS, 554 F.2d 1173, 1177 & n.28 (D.C. Cir. 1977).

185See Forsyth Memorial Hosp., Inc. v. Sebelius, 639 F.3d 534, 537 (D.C. Cir. 2011) (citing Troy Corp. v. Browner, 120 F.3d 277, 281 (D.C. Cir. 1997)).

186Int’l Swaps and Derivatives Ass’n. v. CFTC at 266.

187Id.

188Id.
In the view presented by ISDA and SIFMA, the necessity standard applied to any position limits set pursuant to Dodd-Frank. ISDA and SIFMA also argue that the CFTC failed to find that it was appropriate to set position limits, in violation of the clear language of Sections 6a(a)(2) and (a)(5). They argued that the “as appropriate” modified the “shall” and imposed a requirement on the CFTC to only set limits if the CFTC found it appropriate to do so.

Lastly, ISDA and SIFMA argued that the CFTC’s interpretation of the CEA was internally inconsistent. By imposing position limits for contracts related to only certain (and not all) commodities, the Commission “acknowledged that it had the discretion to establish position limits for some commodity contracts and not others.” They argue that nowhere in the CEA is there a distinction between the commodities.

ISDA and SFIMA argued that “if, as the [CFTC] concede[d], the statute [did] not require the [CFTC] to establish position limits for all commodities, there is no textual basis to conclude that it [was] required to regulate any of them.”

In its counterargument, the CFTC also argued that Section 6a of the CEA is clear and unambiguous. The CFTC took the position that Congress mandated the CFTC to set position limits and stripped it of all discretion not to impose such limits. The CFTC argued that it was not required to find that position limits were necessary or appropriate before imposing them because since Congress added Sections 6a(a)(2)-(7) that meant they had made the imposition of speculative limits mandatory. Specifically, the CFTC points out that Congress stated that “with respect to physical commodities . . . the Commission shall by rule, regulation or order establish limits on the amounts of positions, as appropriate, . . . that may be held by any person . . . .”

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189 See 7 U.S.C. § 6a(a)(2) (stating that position limits shall be established “[i]n accordance with the standards set forth in paragraph (1) of this subsection . . . .”).

190 See Id. at 6(a)(2)(A) (“the Commission shall by rule, regulation, or order establish limits on the amount of positions, as appropriate . . . that may be held by any person . . . .”) (emphasis added); 6a(a)(5) (“the Commission shall establish limits on the amount of positions, including aggregate position limits, as appropriate, . . . .”) (emphasis added).

191 Int’l Swaps and Derivatives Ass’n. v. CFTC at 266-67.

192 Id. at 267; 76 Fed. Reg. at 71665.

193 Int’l Swaps and Derivatives Ass’n. v. CFTC at 267.

194 Id.

195 Id.

196 Id.

197 7 U.S.C. § 6a(a)(2)(A); Int’l Swaps and Derivatives Ass’n. v. CFTC at 267.
The CFTC also argued that Congress referred to the position limits as “required” and imposed time limits on the agency under Sections 6a(a)(2)(B)(i) (“... the limits required under subparagraph (A) shall be established within 180 days ...”) and 6a(a)(2)(B)(ii) (“... the limits required under subparagraph (A) shall be established within 270 days ...”). According to the CFTC, if Congress intended for the CFTC to establish limits on a case-by-case basis, it would not have required that the limits be imposed on such short deadlines.  

Finally, the CFTC argued that, under Dodd-Frank, Congress directed the CFTC to “conduct a study of the effects (if any) of the position limits imposed ... within 12 months after the imposition of the limits.” Congress further directed that the CFTC “shall” submit a copy of that report to Congress, and Congress shall conduct a hearing within 30 days. According to the CFTC, the reporting requirement was further evidence that the Dodd-Frank amendments mandated the Commission to set limits.

### 4.5 Court Findings

The first question the Court answered was whether, or not, Section 6a(a)(1) required the CFTC to find position limits were necessary prior to imposing them. Finding that the statue did require the CFTC to ensure the position limits were necessary prior to imposing, the Court pointed out that the statue required position limits to be set as the “CFTC [found were] necessary to diminish, eliminate, or prevent [excessive speculation].” The Court found that the text did not state, nor did it ever, that the CFTC could do away with or ignore the necessity requirement in its discretion.

The next question for the Court was whether, or not, the CFTC was under a mandate by Congress to set position limits. The Court held that there was not a mandate for the CFTC to establish position limits. The Court holds that because the first part of Section 6a(a)(2) begins with “[i]n accordance with the standards set forth in paragraph (1) ... the CFTC shall by rule, regulation, or order establish limits on the amounts of positions...” that the CFTC was directed to set limits in accordance with the necessity parameters set forth in paragraph (1).

To determine the meaning of “as appropriate” in the CEA, the Court first outlined that the “as appropriate” language appeared in three contested sections of the CEA:

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198 *Int’l Swaps and Derivatives Ass’n v. CFTC* at 267.


200 *Int’l Swaps and Derivatives Ass’n v. CFTC* at 268.

201 *Id.* at 269.

202 *Id.* at 270.

203 *Id.* at 273-74.

204 *Id.* at 276.
Section 6a(a)(2)(A):

In accordance with the standards set forth in paragraph (1) of this subsection . . . the [CFTC] shall by rule, regulation, or order establish limits on the amount of positions, as appropriate, other than bona fide hedge positions, that may be held by any person . . .

Section 6a(a)(3):

In establishing the limits required in paragraph (2), the [CFTC], as appropriate, shall set limits – (A) on the number of positions that may be held by any person for the spot month, each other month, and the aggregate number of positions that may be held by any person for all months; and

(A) to the maximum extent practicable, in its discretion . . .

Section 6a(a)(5)(A):

Notwithstanding any other provision of this section, the [CFTC] shall establish limits on the amount of positions, including aggregate position limits, as appropriate, other than bona fide hedge positions . . .

In its argument to the Court, the CFTC contended that Congress meant “as appropriate” in Sections 6a(a)(2)(A) and 6a(a)(5)(A) to modify the actual levels of the limits. ISDA and SIFMA contended that “as appropriate” was meant to modify “shall.” The Court could not conclude whether the “as appropriate” clauses were meant to modify the verb “shall” or whether it was meant to only to grant the CFTC authority to set the “amount of positions” as it saw “appropriate.”

ISDA, SIFMA and the CFTC did not dispute that Section 6a(a)(6) was a mandate upon the CFTC to set aggregate position limits. The Court did decline, however, to reach a determination as to whether, or not, the aggregation standards promulgated by the final rule were arbitrary and capricious 5 U.S.C. § 706(2)(A) or in violation of the cost-benefit analysis requirements of 7 U.S.C. § 19.

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205 *Id.* at 276.

206 *Id.*

207 *Id.* at 278.

208 *Id.* at 278; *See also* 7 U.S.C. § 6a(a)(6)(A)-(C).

209 *Id.* at 280.
The Court also declined to determine whether, or not, the CFTC’s aggregation policies should be severed from the Final Rule.  

The Court continued its review by emphasizing that it needed to review the entire Section 6a, as a whole. By doing this, the Court found that the CEA could have two plausible readings.  

First, the CFTC’s reading, which was that the CFTC was mandated to set position limits and that it was not required to find (either implicitly or explicitly) that the imposition of position limits both generally and with respect to certain commodities was necessary, and that it was required to set those limits within a short time frame. The second interpretation was offered by ISDA and SIFMA, which argued that the “only reasonable reading of the Dodd-Frank amendments to Section 6a is that Congress intended the CFTC to immediately gather evidence relating to whether excessive speculation was harming commodity markets and to impose position limits where necessary and appropriate to prevent an undue burden on the economy.”

When a statute is ambiguous, relevant case law requires the CFTC not to rest simply on its parsing of the statutory language. It must bring its experience and expertise to bear in light of competing interests at stake” to resolve the ambiguities in the statute. The Court, therefore, remanded the Final Rule back to the CFTC so that it could fill in the gaps and resolve the ambiguities.

210The CFTC informed the Court that it had issued a Notice of Proposed Rulemaking (“Aggregation Notice”) to revisit “several provisions” of the Position Limits Rule governing aggregation of speculative positions. Id. at 278; See also Id. (stating that, through the Aggregation Notice, CFTC is considering proposed changes to seven aggregation provisions of final rule). At the time, the CFTC was considering whether to modify many of the aggregation provisions with which ISDA and SIFMA took issue in this case; See Aggregation Position Limits for Futures and Swaps, 77 Fed. Reg. 31767 (May 30, 2012) (proposing amendments to, among other provisions, the information sharing exemption and the 10% ownership standard). Because the aggregation rules were currently under consideration and may be changed after the Position Limits Rule goes into effect, the CFTC’s Division of Market Oversight also issued a “no action” letter to all market participants excusing them from compliance with certain portions of the rule under certain circumstances. Int’l Swaps and Derivatives Ass’n v. CFTC at 278.

211Int’l Swaps and Derivatives Ass’n v. CFTC at 279.

212Id.

213Id. at 280.

214PDK Labs v. U.S. DEA, 362 F.3d 786, 794, 797-98 (holding that agency’s interpretation of statute was not entitled to deference because agency erroneously believed the meaning of the statute was plain and failed to rely on its expertise to discern the meaning of the statute); See also Peter Pan Bus Lines, Inc v. Fed. Motor Carrier Safety Admin., 471 F.3d 1350, 1354 (D.C.Cir.2006); Arizona v. Thompson, 281 F.3d 248, 254 (D.C.Cir.2002). Where an agency has failed to do so, it “is not for the court ‘to choose between competing meanings.’” PDK Labs., 362 F.3d at 797-98 (quoting Alarm Indus. Commc’ns Comm. v. FCC, 131 F.3d 1066, 1072 (D.C.Cir. 1997)) (holding that Court must remand to the agency to resolve the ambiguity in the statute). “[I]f we find that an agency’s stated rationale for its decision is erroneous, we cannot sustain its action on some other basis the agency did not mention.” PDK Labs. at 798 (citing SEC v. Chenery Corp., 332 U.S. 194, 200 (1947)).

215See PDK Labs. at 798; see also Alarm Indus. at 1072 (holding that statute did not have a plain meaning, as the Commission believed it did, and vacating and remanding the case to the Commission to resolve the ambiguity); Humane Soc’y of U.S v. Kempthorne, 579 F. Supp.2d 7, 13 (D.D.C.2008) (noting that “when an agency wrongly
4.6 Vacated Final Rule

The Court vacated the Final Rule and determined that maintaining the status quo would be the best course of action to minimize disruption to the market. Additionally, the Court remanded the Final Rule back to the CFTC for further analysis.

5. CFTC Second Proposed Position Limit Rules – December 2013

5.1 Introduction

On December 12, 2013, the CFTC proposed, for a second time, speculative position limit rules (the “CFTC 2013 Proposed Rules”) for twenty-eight (28) exempt and agricultural commodity futures and options contracts and physical commodity swaps that are “economically” equivalent to such contracts. Additionally, the CFTC proposed to update some relevant definitions, revise the exemptions from speculative position limits, including bona fide hedging and extend and update reporting requirements for exempt persons. The CFTC also included: (1) guidance on risk management exemptions for commodity derivative contracts in excluded commodities permitted under the bona fide hedge exemption, (2) a list of Core Referenced Futures Contracts and commodities that would be substantially the same as a commodity underlying a Core Referenced Futures Contract; (3) a description and analysis of fact patterns that would satisfy the definition of a bona fide hedging position; and (4) a table of proposed speculative position limits. In addition, the CFTC also proposed updates to its rules, guidance and acceptable practices for DCM core principle 5 and SEF core principle 6 in respect to exchange-set speculative position limits and position accountability levels.

5.2 Necessity

In the CFTC 2013 Proposed Rules, the CFTC set out a robust factual analysis as to the necessity for speculative position limits, citing marketing manipulation events, large historical swings in the market, historical large trader reports and debunking studies that claimed speculative position limits were not the proper tool to address the problem of excessive speculation.

5.3 Definitions

The CFTC proposed to amend the definition of: (1) futures equivalent, (2) independent account controller, (3) long position, (4) short position and (5) “spot month”. The CFTC also proposed concludes that its interpretation is mandated by the statute, a court will not impose its own interpretation of the statute.”).

\[216\text{Int’l Swaps and Derivatives Ass’n. v. CFTC, at 284.}\]

\[217\text{78 Fed. Reg. 75680 (Dec. 12, 2013).}\]

\[218\text{Id.}\]

\[219\text{Id. at 75685.}\]

\[220\text{Id. at 75696.}\]
to add a definition for: (1) basis contract, (2) calendar spread contract, (3) commodity index contract, (4) core referenced futures contract, (5) eligible affiliate, (6) entity, (7) excluded commodity, (8) intercommodity spread, (9) intermarket spread, (10) physical commodity, (11) pre-enactment swap, (12) pre-existing position, (13) “referenced contract, (14) speculative position limit, (15) swap, (16) swap dealer, (17) transition period swap.  In addition, the CFTC proposed to move the definition of bona fide hedging from Section 1.3(z) into part 150 and update it. Some of these amendments are addressed below.

The term “basis contract” is not a defined term in Section 150.1 and although a definition was adopted in Section 151.1, it was later vacated. In the CFTC 2013 Proposed Rules, the CFTC again proposed a definition for the basis contract, meaning, in general, a commodity derivative contract that is cash-settled based on the difference in: (1) the price, directly or indirectly, of: (a) a particular Core Referenced Futures Contract or (b) a commodity deliverable on a particular Core Referenced Futures Contract, whether at par, a fixed discount to par, or a premium to par, and (2) the price, at a different delivery location or pricing point than that of the same particular Core Referenced Futures Contract, directly or indirectly, of: (a) a commodity deliverable on the same particular Core Referenced Futures Contract, whether at par, a fixed discount to par, or a premium to par, or (b) a commodity that is listed to be substantially the same as a commodity underlying this same Core Referenced Futures Contract.

The CFTC proposed the term “commodity derivative contract” as a shorthand for any futures, option or swap contract in a commodity.

The term “commodity index contract” is not a defined term in Part 150.1 and while it was included in Part 151.1, it was vacated. The CFTC proposed the substantially the same language from Part 151.1, with the addition of the provision at the end. Specifically, that a “commodity index contract” means “an agreement, contract, or transaction that is not a basis or any type of spread contract, based on an index comprised of prices of commodities that are not the same or substantially the same, provided that, as commodity index contract used to circumvent speculative position limits would be considered a Referenced Contract for the purposes of applying position limits”.

The definition of Core Referenced Futures Contract from the CFTC 2011 Proposed Rules was proposed again in the CFTC 2013 Proposed Rules.

\[221\text{Id.}\]
\[222\text{Id. (Additionally, the CFTC deleted the definition for the “first delivery month of the crop year”, made some other clarifying changes and alphabetized definitions.)}\]
\[223\text{Id.}\]
\[224\text{Id. at 75697.}\]
\[225\text{Id.}\]
\[226\text{Id.}\]
The CFTC proposed to amend the definition of “eligible affiliate” to mean an “entity with respect to which another person: (1) directly or indirectly holders either (a) a majority of the equity securities of such entity or (b) the right to receive upon dissolution of, or the contribution of, a majority of the capital of such entity; (2) reports its financial statements on a consolidated basis under the Generally Accepted Accounting Principles or International Financial Reporting Standards; and (3) is required to aggregate positions under the aggregation rules and does not claim an exemption."^{227}

The term “excluded commodity” was added to the CEA in the CFMA but was not defined or used in Part 150. Dodd-Frank uses the phrase when it provides for a timeline under which the CFTC must set position limits for futures and option contracts, other than “excluded commodities”.^{228} The CFTC proposes to propose to incorporate its statutory meaning into the CFTC 2013 Proposed Rules.^{229}

The term “futures-equivalent” is currently defined in Part 150.1(f). The CFTC proposed to amend it to mean “an option contract, whether an option on a future or an option that is a swap, which has been adjusted by an economically reasonable and analytically supported risk factor, or delta coefficient, for that option computed as of the previous day’s close or the current day’s close or contemporaneously during the trading day and (2) a swap which has been converted to an economically equivalent amount of an option position in a Core Referenced Futures Contract."^{230} By doing this, the CFTC proposed that the any established position limits would apply across different trading venues to economically equivalent contracts that are based on the same underlying commodity."^{231}

The term “intercommodity spread contract” was introduced and then vacated. The CFTC proposed to simplify its definitions and include this term as part of the definition of a Referenced Contract."^{232}

The CFTC proposed to add a definition for the term “physical commodity” because it was used by Congress in Dodd-Frank to mean commodities “other than excluded commodities as defined by the [CFTC]."^{233} The CFTC interpreted, and therefore proposed, that a physical commodity includes both an exempt and an agricultural commodity."^{234}

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^{227}Id. at 75698.

^{228}Id.

^{229}Id.

^{230}Id. at 75699.

^{231}Id.

^{232}Id.


^{234}Id. at 75700.
The CFTC proposed to mirror the definition for Referenced Contract as it was proposed in the Final Rules, differing only with the addition of a clarification that the definition does not include guarantees of swaps, basis contracts or commodity index contracts.\textsuperscript{235} In the 2013 CFTC Proposed Rules, a Referenced Contract means, on a future equivalent basis with respect to a particular Core Referenced Futures Contract, a futures contract, option contract or a swap, and excluding any guarantee of a swap, a basis contract or a commodity index contract: “(1) That is: (a) directly or indirectly linked, including being partially or fully settled on or priced at a fixed differential to the price of that particular core referenced futures contract, [(b)] directly or indirectly linked, including being partially or fully settled on, or priced at a fixed differential to the price of the same commodity underlying that particular core referenced futures contract for delivery at the same location or locations as specified in that particular core referenced futures contract….”\textsuperscript{236}

The term “speculative position limit” was not previously proposed. In the 2013 CFTC Proposed Rules, the CFTC proposed to define “speculative position limit” to mean “the maximum position, either net long or short, in a commodity derivatives contract that may be held or controlled by one person, absent an exemption, such as an exemption for a bona fide hedging position. This limit may apply to a person’s combined position in all commodity derivative contracts in a particular commodity (all-months-combined), a person’s position in a single month of commodity derivative contracts in a particular commodity and in the person’s position in the spot month”\textsuperscript{237}

The term “spot month” was amended to be the “trading period immediately preceding the delivery period for a physical delivery futures contract as well as for any cash-settled swaps and futures contracts that are linked to the physical-delivery contract.”\textsuperscript{238} In addition, the definition includes a proviso that if the cash-settled price is determined based on prices of a core referenced futures contract during the spot month period for that core referenced futures contract, then the spot month for that cash-settled contract is the same as the spot month for the core referenced futures contract.\textsuperscript{239}

### 5.4 Position Limits

As written above, the CFTC had historically been setting and enforcing speculative position limits on futures and options for certain enumerated agricultural products. Under Dodd-Frank, the CFTC was to extend its position limit rules to beyond futures and options contracts to swaps traded on DCMs and SEFs and swaps not traded on DCMs or SEFs that perform or affect a significant price discovery function. Further, Dodd-Frank, required speculative position limits to

\textsuperscript{235} Id. at 75701.

\textsuperscript{236} 17 C.F.R. § 150.1 (2011).


\textsuperscript{239} 78 Fed. Reg. 75702 (Dec. 12, 2013).
be applied to swaps that were the “economic equivalent” to DCM futures and options contracts for agriculture and exempt commodities, which included energy commodities. All of which were required to be implemented on an aggregated basis.  

As in the Final Rules, the CFTC 2013 Proposed Rules would list spot month, single month, and all-month position limits for twenty-eight (28) Core Referenced Futures Contracts and to the Referenced Contracts, including economically equivalent contracts. These proposed position limits would apply across all trading venues under CFTC jurisdiction.

The CFTC 2013 Proposed Rules provided that no person could hold or control positions in Referenced Contracts in the spot month, single-month or all month, net long or net short, in excess of the position limit level set by the CFTC for physical-delivery Referenced Contracts and financially-settled Referenced Contracts.

In the CFTC 2013 Proposed Rules the CFTC adopted a phased approach to the implementation of position limits for each of the twenty-eight Core Referenced Futures Contracts, based upon a calculation of open interest.

The CFTC proposed to set the initial spot month position limit levels for Referenced Contracts to be the then existing DCM-set levels for the Core Referenced Futures Contracts. As an alternative, the CFTC proposed to use the estimated deliverable supplies submitted by the CME group to calculate twenty-five (25) percent thereof, which would serve as the spot month limit. The CFTC proposed to set the single-month and all-month position limits based on total open interests for all referenced contracts in a commodity. The actual position limit level will be based upon a formula: (1) ten percent of the open interest for the first 25,000 contracts and 2.5 percent of the open interest thereafter.

The CFTC 2013 Proposed Rules applied position limits to foreign board of trade (“FBOT”) contracts that are both: (1) linked contracts, that is, a contract that settles against the price

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240 Id. at 75723.


242 Id.


244 Id. at 75724.

245 Id. at 75725-26.

246 Id. at 75727.

247 Id.

248 Id. at 75729.

249 Id.
(including the daily or final settlement price) of one or more contracts listed for trading on a DCM or SEF and (2) direct access contracts, that is, the FBOT makes the contract available in the U.S. through direct access electronic trading and order matching.\footnote{Id. at 75735.}

In addition to the bona fide hedging exemption, the Final Rules provided for an exemption for spread or arbitrage positions between single months of a futures contract (or option contract). Additionally, there was an exemption proposed for positions carried for an eligible entity in a separate account of an independent account controller that manages customers’ positions.\footnote{17 C.F.R. § 150.2 (2011); 78 Fed. Reg. 75735 (Dec. 12, 2013).} In the CFTC 2013 Proposed Rules, the independent account controller exemption would be cross-referenced in the aggregation requirements and the second exemption would be deleted in its entirety, due to it no longer being necessary given the proposed changes to the position limit rules.\footnote{17 C.F.R. § 150.3 (2011); 78 Fed. Reg. 75735 (Dec. 12, 2013).} Additionally, the CFTC proposed to add exemptions for situations of financial distress, certain spot-month positions in cash-settled referenced contracts and grandfathered pre-Dodd-Frank and transition period swaps.\footnote{78 Fed. Reg. 75735 (Dec. 12, 2013).} The CFTC also proposed to revise the recordkeeping and reporting requirements for traders claiming any exemption.\footnote{Id.} The proposed recordkeeping and reporting requirements required the maintenance of complete books and records concerning all details of the trader’s related cash, forward, futures, options and swap positions and transactions.\footnote{Id. at 75741.} Further, it was required that these records be made available to the CFTC upon request.\footnote{17 C.F.R. § 150. 7 (2011).} The CFTC 2013 Proposed Rules set out requirements for anticipatory bona fide hedging.\footnote{Id.} To obtain this exemption, the trader needed to file Form 704, in advance of amassing a position above the speculative position limit.\footnote{Id.}

6. **CFTC Proposed Amendments to Bona Fide Hedging Exemption – December 2013**

The CFTC proposed to deleted the current definition of bona fide hedging in Section 1.3(z)\footnote{Id. at § 1.3(z) (2011).} and replace it with a new definition.\footnote{78 Fed. Reg. 75706 (Dec. 12, 2013).} The CFTC 2013 Proposed Rule proposal for the definition of bona fide hedging building upon the CFTC’s history in administering a regulatory
exemption to federal limits and providing guidance to the exchanges in establishing exchanges limits and is grounded for physical commodities.\textsuperscript{261} The proposed definition was organized into six (6) sections: an opening paragraph with two general requirements for all hedges and five numbered paragraphs.\textsuperscript{262} Paragraph one set forth the requirements for hedges of excluded commodities and incorporated guidance on risk management exemptions that may be adopted by exchanges.\textsuperscript{263} Paragraph two listed requirements for hedges of a physical commodity.\textsuperscript{264} Paragraph three and four listed enumerated exemptions and paragraph five listed specific requirements for cross-commodity hedges.\textsuperscript{265}

The opening paragraph set out two general requirements for a legitimate hedging position: (1) the purpose of the position must be to offset price risk incidental to commercial cash operations (the “\textit{Incidental Test}”) and (2) the position must be established and liquidated in an orderly manner in accordance with sound commercial practices (the “\textit{Orderly Trading Requirement}”).\textsuperscript{266}

For “excluded commodities” the proposed guidance provided that, in addition to the Incidental Test and the Orderly Trading Requirement, for the position to be a bona fide hedging position it must also be: (1) economically appropriate to reduce the risk in the conduct and management of the commercial enterprise (the “\textit{Economically Appropriate}”)\textsuperscript{267} and (2) either: (a) enumerated as a bona fide hedge in paragraphs (3)-(5) of the definition or (b) recognized as a bona fide hedge by the DCM or SEF.\textsuperscript{268} In addition, under the proposed guidance, stated that there is no need to conduct a temporary substitute test for a bona fide hedge in an “excluded commodity.”\textsuperscript{269}

In the definition of bona fide hedges for physical commodities, the CFTC proposes that such physical commodity position is a bona fide hedge when: (1) it represents a substitute for transactions made or to be made, or positions taken or to be taken, at a later time in a physical commodity market, (2) it is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, (3) arises from the potential change in value of: (a) assets, (b) liabilities, (c) services, (4) is enumerated as a bona fide hedge under the definition itself.\textsuperscript{270} Further, the proposed definition provided that a bona fide hedge in a commodity

\textsuperscript{261}Id.
\textsuperscript{262}Id.
\textsuperscript{263}Id.
\textsuperscript{264}Id.
\textsuperscript{265}Id.
\textsuperscript{266}Id. at 7506-7.
\textsuperscript{267}Id. at 7507.
\textsuperscript{268}Id.
\textsuperscript{269}Id. at 75708.
derivate contract in a physical commodity is a bona fide hedge if such position reduces risks attendant to a position resulting from a swap in the same physical commodity that was executed opposite a country for which the position at the time of the transaction would qualify as a bona fide hedging position, provided that no such risk reducing position is maintained in any physical-delivery commodity derivative contract during the lesser of the last five days of trading or such time period for the spot.\(^271\)

The enumerated hedging position included: (1) hedges of inventory and cash commodity purchase contracts, (2) hedges of cash commodity sales contracts, (3) hedges of unfilled anticipated 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.\(^272\)

The requirements for cross-commodity hedges added that positions used to offset the risks arising from a commodity other than the same cash commodity underlying the commodity derivative contract would also be considered a bona fide hedge, provided that the fluctuations in value of the position in the commodity derivative contract or the commodity underlying the commodity derivative contract, were substantially related to the fluctuations in value of the actual or anticipated cash position or pass-through swap and no such position was maintained in any physical delivery commodity derivative contract during the last five days of trading or the time period for the spot month for such physical-delivery contract.\(^273\)

7. **CFTC Third Proposed Position Limit Rules – December 2016**

   **7.1 2016 Supplemental Position Limit Proposal**

On June 13, 2016, the CFTC published a supplemental proposal to its December 2013 Position Limits rulemaking (the “\(^274\)2016 Supplemental Position Limits Proposal”),\(^274\) The supplemental proposal included revisions and additions to regulations and guidance proposed in CFTC 2013 Proposed Rules concerning speculative position limits in response to comments received on that proposal, and alternative processes for DCMs and SEFs to recognize certain positions in commodity derivative contracts as non- enumerated bona fide hedges or enumerated anticipatory bona fide hedges, as well as to exempt from federal position limits certain spread positions, in each case subject to the CFTC’s review.\(^275\) In this regard, under the 2016 Supplemental Position Limits Proposal, certain of the regulations proposed in the CFTC 2013 Proposed Rules regarding exemptions from federal position limits and exchange-set position limits would be amended to take into account the alternative processes.\(^276\) In connection with those proposed changes, the


\(^{273}\)Id.


\(^{276}\)Id.
CFTC proposed to further amend certain relevant definitions, including to clearly define the general definition of bona fide hedging for physical commodities. Separately, the CFTC proposed to delay for DCMs and SEFs that lack access to sufficient swap position information the requirement to establish and monitor position limits on swaps at this time. After review of the comments responding to both the December 2013 Position Limits Proposal and the 2016 Supplemental Position Limits Proposal, the CFTC, in consideration of those comments, is issued a reproposal of the position limit rules.\textsuperscript{277}

For the third time since the enactment of Dodd-Frank, the CFTC proposed position limit rules on December 30, 2016 (the “\textit{CFTC 2016 Proposed Rules}”\textsuperscript{278}). The CFTC 2016 Proposed rules established speculative position limits for twenty-five (25) exempt and agricultural commodity futures and options contracts, and physical commodity swaps that are “economically equivalent” to such contracts.\textsuperscript{279} In connection with establishing these limits, the CFTC proposed to: (1) update some relevant definitions, (2) revise the exemptions from the speculative position limits, including bona fide hedging, and (3) extend and update reporting requirements for claiming exemptions from the position limits.\textsuperscript{279} Additionally, the CFTC updated its guidance on risk management exemptions for commodity derivative contracts in excluded commodities, list core referenced futures contracts and commodities that would be substantially the same as a commodity underlying a core referenced futures contract.\textsuperscript{280} Further, the CFTC proposed an update to its rules, guidance, and acceptable practices for compliance with DCM core principle 5 and SEF core principle 6 in respect to exchange set speculative position limits and position accountability levels. Separately, the CFTC proposed to delay for DCMs and SEFs that lacked access to sufficient swap position information the requirement to establish and monitor position limits on swaps.\textsuperscript{281}

### 7.2 Compliance Date

The CFTC 2016 Proposed Rules proposed to delay the compliance date for any final position limit rule to January 3, 2018, at the earliest.\textsuperscript{282} The CFTC delayed the compliance date in order to provide market participants with sufficient time to come into compliance with a final rule, particularly to obtain adequate systems to compute the future-equivalent positions.\textsuperscript{283}

### 7.3 Definitions

\textsuperscript{277}Id.


\textsuperscript{280}Id.

\textsuperscript{281}Id.


The CFTC repurposed the amendments to the definitions from the CFTC 2013 Rule Proposals, with a few modifications.\footnote{Id.} The CFTC reproposed the definition of “basis contract” and changed it to “location basis contract.”\footnote{Id.} The reason for this change was because the CFTC intended this definition to encompass contracts that settle to the difference between prices in separate delivery locations of the same (or substantially the same) commodity, while the industry seemed to use the term “basis contract” more broadly to include other price differentials.\footnote{Id.}

In the CFTC 2016 Proposed Rules, the CFTC reproposed the definition of “futures equivalent”, by adopting the exchange practice with regards to option assignments.\footnote{Id. at 96733.} This practice uses a risk (delta) model to determine futures equivalents for options.\footnote{Id.} Additionally, and among other reproposed definitions, the CFTC also decided to repropose the definition of “long position” and “short position” to clarify that: (1) a long-position on a futures-equivalent basis is a futures contract, or swap position, that is equivalent to a long futures contract\footnote{Id. at 96734.} and (2) a short position on a futures-equivalent basis is a short call option, a long put option, a short underlying futures contract, or a swap position that is equivalent to a short futures contract.\footnote{Id. at 96739.}

The CFTC reproposed the definition of “referenced contracts” with two substantive modifications.\footnote{Id.} First, the CFTC proposed to amend the definition of “referenced contract” to expressly exclude trade options.\footnote{Id. at 96735.} Second, the CFTC 2016 Proposed Rules would clarify the meaning of “indirectly linked.”\footnote{Id.} The CFTC 2016 Proposed Rules also moved four definitions that were embedded in the CFTC 2013 Proposed Rule definition of referenced contract, specifically “calendar spread contract,” “commodity index contract,” “spread contract,” and “intercommodity spread contract,” to their own definitions.\footnote{17 C.F.R. § 150.1 (2011).} In addition, the CFTC 2016 Proposed Rules makes non-substantive modifications to the definition of referenced contract to make it easier to read.\footnote{81 Fed. Reg. 96735 (Dec. 30, 2016).} With regards to the clarification of “indirectly linked” the CFTC explained that this means contracts that are “indirectly linked” to the core referenced futures
contract under the definition of referenced contract and that this definition is intended to prevent the evasion of position limits through the creation of an economically equivalent contract that does not directly reference the core referenced futures contract.296

The CFTC 2016 Proposed Rules proposed a change to the definition of “spot month” to be the same as the definition of spot month for exchange limits.297 Under the CFTC 2016 Proposed Rules, the “spot month” means the period of time beginning at the earlier of the close of business on the trading day preceding the first day on which delivery notices can be issued by the clearing organizations of a contract market, or the close of business on the trading day preceding the third-to-last trading day, until the contract expires for physical delivery core referenced futures contracts, except for: (1) ICE Futures U.S. Sugar No. 11 (SB) referenced contract for which the spot month means the period of time beginning at the opening of trading on the second business day following the expiration of the regular option contract; (2) ICE Futures U.S. Sugar No. 16 (SF) referenced contract, for which the spot month means the period of time beginning on the third-to-last trading day of the contract month until the contract expires and (3) CME Live Cattle (LC) referenced contract, for which the spot month means the period of time beginning at the close of trading on the fifth (5th) business day of the contract month.298

7.4 Position Limits

The CFTC had determined in the CFTC 2016 Proposed Rules that the part 20 large trader reports provided reliable data and repoposed the non-spot month position limits based upon the part 20 swaps data and data on open interest in physical commodity futures and options from relevant exchanges.299 For the spot-month position limits, the CFTC 2016 Proposed Rules sets the limits for soft commodities (e.g. coffee, cocoa, cotton, sugar) in the Core Referenced Futures Contracts to be twenty-five (25) % of the estimated deliverable supply, based on the estimates of deliverables submitted by ICE.300 For metals, the CFTC 2016 Proposed Rules repoposed spot-month limits based upon recommended levels submitted by the CME, all of which are lower than the twenty-five (25) % of the estimated deliverable supply.301 The CFTC had proposed to set the spot month limit for energy commodities at twenty-five (25) % of estimated deliverable supply, which for some of the energy commodities (e.g. natural gas, heating oil and gasoline) is higher than the levels recommended by CME.302

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296 Id.
297 Id. at 96740.
300 Id. at 96761.
301 Id. at 96762.
302 Id. at 96764.
To set the single-month and all month position limits, the CFTC had used the futures position limit formula, ten (10) % of the open interest for 25,000 contracts and 2.5 % of open interest thereafter.\footnote{Id. at 96765.} The CFTC 2016 Proposed Rules set the non-spot month position limits for corn, oats, rough rice, soybeans’, soybean meal and wheat based on this same ten (10) and then 2.5 % formula.\footnote{Id.} For hard red winter wheat and hard red spring wheat Core Referenced Futures Contracts, the CFTC set the position limits at 12,000 contracts rather than reducing them to the lower level that would result from applying the formula.\footnote{Id.} The CFTC 2016 Proposed Rules set the non-spot month position limit levels for metals and energy commodities using the 10, 2.5 % of open interest formula.\footnote{Id.}

In the CFTC 2016 Proposed Rules the CFTC will reestablish position limit levels every two calendar years, although the CFTC has the discretion to maintain the position limit levels.\footnote{17 C.F.R. § 150.2 (2011); 81 Fed. Reg. 96769-70 (Dec. 30, 2016).}

The CFTC 2016 Proposed Rules does not repropose position limits on three (3) cash-settled core referenced futures contracts: (1) CME class III Milk, (2) CME Feeder Cattle and (3) CME Lean Hogs.\footnote{81 Fed. Reg. 96773 (Dec. 30, 2016).} As part of the phased approach, the CFTC determined that it will defer implementing position limits on all physical commodity derivative contracts to a later date.\footnote{Id.}

With regards to the CFTC 2013 Proposed Rules list of three enumerated exemptions: (1) bona fide hedges, (2) the exemption for spread positions between single months of futures contracts outside the spot month, provided the trader’s spread position in a sing month does not exceed the all-month limit, and (3) the IAC exemption, the CFTC reproposes them in its entirety.\footnote{17 C.F.R. § 150. (20311); 81 Fed. Reg. 96774-74 (Dec. 30, 2016).}

In the CFTC 2013 Proposed Rules, the CFTC required recordkeeping and reporting for any person claiming an exemption from the position limits and permitted the CFTC to review such records, in its discretion.\footnote{81 Fed. Reg. 96781 (Dec. 30, 2016).} The CFTC reproposed the recordkeeping and reporting requirements in the CFTC 2016 Proposed Rules.\footnote{17 C.F.R. § 150.3 (2011); 81 Fed. Reg. 96781 (Dec. 30, 2016).}
SEF Core Principle 6 requires SEFs to: (1) set position limits on swaps at a level no higher than that of the federal position limit and (2) monitor positions established on or through the SEF for compliance with the federal limit and any SEF set limit.\(^\text{313}\) Under DCM Core Principle 5, DCM’s must set position limits no higher than federal position limits.\(^\text{314}\) In the 2016 Supplemental Position Limits Proposal, the CFTC decided to temporarily delay for DCMs and SEFs the requirement of setting limits, due to the lack of sufficient swap position information and the need for the implementation of monitoring technology.\(^\text{315}\) The CFTC 2016 Proposed Rules maintained this temporary delay.\(^\text{316}\)

The CFTC 2016 Proposed Rules maintained the requirement to file Form 704 for anticipatory hedges, but did update the regulation to make these requirements more clear and concise.\(^\text{317}\) For example, the CFTC maintained the requirement for an initial filing and an annual update but removed the requirement for supplemental reports.\(^\text{318}\) Additionally, the CFTC clarified that if the CFTC does not respond to the 704 filing in the timeframe given in the regulations, then the filing becomes effective automatically.\(^\text{319}\)

In section 150.9 of the CFTC 2016 Proposed Rules, the CFTC enumerated the process by which exchanges could recognize non-enumerated bona fide hedging positions, so long as the recognition is consistent with the CFTC’s definition of a bona fide hedging position, allowing exchanges to exempt anticipatory hedges and exemptions during the last five (5) days of trading.\(^\text{320}\) The CFTC 2016 Proposed Rules also established a process for DCMs and SEFs to exempt certain spread positions from position limits.\(^\text{321}\) Section 150.11, created a process to recognize unfilled anticipated requirements, unsold anticipated production, anticipated royalties, anticipated service contract payments or receipts, or anticipatory cross-commodity hedge positions as bona fide hedges.\(^\text{322}\)

8. CFTC Proposed Amendments to Bona Fide Hedging Exemption – December 2016

\(^\text{314}\)Id.
\(^\text{315}\)Id. at 96784.
\(^\text{316}\)Id. at 96786.
\(^\text{319}\)Id.
\(^\text{321}\)17 C.F.R. § 150.10 (2011).
\(^\text{322}\)Id. at § 150.11.
Under the CFTC 2013 Proposed Rules, the CFTC proposed a new definition of bona fide hedging to replace the then current definition in Section 1.3(z), that would be applicable to positions in excluded commodities and physical commodities. In response to comments received to the CFTC 2013 Proposed Rules, the CFTC amended the definition in the 2016 Supplemental Proposal to no longer apply the two (2) general requirements (the Incidental Test and the Orderly Trading Requirement).

For excluded commodities, the CFTC 2016 Proposed Rules proposed substantially mirrors the 2013 CFTC Proposed Rules that an a bona fide hedging position in an excluded commodity must be Economically Appropriate and be specifically enumerated as a bona fide hedging position under the regulation itself or recognized as a bona fide hedge by a DCM or SEF. The one clarification provided under the CFTC 2016 Proposed Rules is that the DCMs and SEFs may recognize risk management exemptions in excluded commodities, without regard to the Economically Appropriate test. Further, the CFTC allows DCMs and SEFs to use its reasonable discretion to grant risk management exemptions and that the lists given by the CFTC in the regulation itself is not an exhaustive list, but just a list of examples.

The CFTC received numerous comments on its CFTC 2013 Proposed Rules definition of a bona fide hedge for physical commodities. After deliberation and examination of these comments, the CFTC 2016 Proposed Rules decided to maintain the temporary substitute test. In the CFTC 2013 Proposed Rules, the CFTC proposed to grandfather previously granted risk-management exemptions. Under the CFTC 2016 Proposed Rules, the CFTC clarifies and expands this grandfather risk-management exemption by: (1) clarifying that such previously granted exemptions may apply to pre-existing financial instruments, rather than only pre-existing swaps and (2) recognizing exchange-granted non-enumerated exemptions in non-legacy commodity derivatives outside the spot-month. These two changes were intended to reduce the potential for market disruption by forced liquidations, since a market intermediary would continue to be able to offset risks of pre-effective-date financial instruments, pursuant to previously granted federal or exchange risk management exemptions.

324 Id. at 96743.
325 Id. at 96744.
326 Id.
327 Id.
328 Id. at 96745.
329 Id.
330 Id. at 96746.
331 Id.
The CFTC 2016 Proposed Rules maintained the CFTC’s position on economically appropriate gross hedging satisfying the bona fide hedge exemption where net hedging does not measure all risk exposures.  

The CFTC 2016 Proposed Rules continued to recognize as bona fide hedging positions the anticipatory hedging of unfilled requirements and unsold production. Additionally, the CFTC recognized anticipatory hedges for anticipated royalties and contracts for services.

The CFTC 2016 Proposed Rules retained the change in value requirement for bona fide hedges. Further, the CFTC 2016 Proposed rules recognized that exchanges could accept anticipated merchandising or anticipated purchase and storage as potential non-enumerated bona fide hedging positions, subject to an assessment of the particular facts and circumstances.

The CFTC 2013 Proposed Rules recognized as a bona fide hedge a commodity derivative contract that reduces the risk of a position resulting from a swap executed opposite a counterparty for which the position at the time of the transaction would qualify as a bona fide hedging position as the pass-through swap. The CFTC 2013 Proposed Rules did not, however, recognize as a bona fide hedge an offset in physical-delivery contract during the shorter of the last five (5) days of trading or the time period for the spot month in such physical delivery commodity derivative contract. The CFTC 2016 Proposed Rules retains and clarifies the pass-through swap exemption, clarifying that the determination as to whether the opposite transaction would qualify as a bona fide hedge should be determined at the time of the transaction by such counterparty. In addition, the CFTC 2016 Proposed Rules maintains the five (5) day rule, however, the CFTC allowed exchanges to determine, on a case-by-case basis, a pass-through offset during the last five (5) days of trading, pursuant to a process outlined in the regulation.

In the CFTC 2013 Proposed Rules, the CFTC recognized as bona fide hedges transactions enumerated in paragraphs (3), (4) and (5) of its regulations. In the CFTC 2016 Proposed

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332 Id. at 96747.
333 Id. at 96748.
334 Id.
335 Id.
336 Id. at 96749.
337 Id. at 96750.
338 Id.
339 Id. at 96751.
Rules, the CFTC retains this position, but added that any position that has been recognized by the DCMs or SEFs, in accordance with the procedures in the regulations, may also be recognized as a bona fide hedge. In paragraph (4) of the CFTC 2013 Proposed Rules, the definition of a bona fide hedge position included: (a) hedges of unsold anticipated production, (b) hedges of offsetting unfixed-price cash commodity sales and purchases, (c) hedges of anticipated royalties and (d) hedges of services. The CFTC applied the five (5) day rule to such positions. The CFTC 2016 Proposed Rules maintains these enumerated exemptions with two amendments. First, the CFTC removes the twelve (12) month constraint on hedging unfilled anticipated requirements for agricultural commodities. Second, the CFTC removes the condition that a utility be “required or encouraged to hedge by its public utility commission.” The CFTC maintained the five (5) day rule, however, as discussed above, the CFTC 2016 Proposed Rules will allow exchanges to remove the five (5) day rule on a case-by-case basis in physical delivery contracts, as a non-enumerated bona fide hedging position, by applying the exchange’s experience and expertise in protecting its own physical-delivery market.

In the CFTC 2013 Proposed Rules, the CFTC recognized cross-commodity hedges as bona fide hedges with certain conditions and a non-exclusive safe harbor. Comments received by the CFTC argued that the conditions and the safe harbor was confusing. The CFTC 2016 Proposed Rules clarified the safe harbor by removing the quantitative test to determine its application.

The CFTC 2016 Proposed Rules specified that a commodity trade option meeting certain requirements may be deemed to be a bona fide hedge.


The current state of the position limit rules is one in flux. Although the multiple position limit rule changes have left market participants with a feeling of uncertainty, that uncertainty is not because of the number of rule changes but because of their complexity and the lack of clarity surrounding the bona fide hedging exemption. For example, the CFTC 2016 Proposed Rules is extremely complex, providing 280 pages of commentary and over approximately 1,730

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344 Id.

345 Id.

346 Id.

347 Id.

348 Id. at 96753.

349 Id.

350 Id.
footnotes. Plus, the incorporation of bits and pieces of the CFTC 2013 Proposed Rule and the separate 2016 Supplemental Position Limits Proposal into the commentary of the CFTC 2016 Proposed Rules also leads to confusion and a lack of clarity.

Commissioner Quintenz argues that the CFTC must revisit the CFTC 2016 Proposed Rules yet again and simplify.\textsuperscript{351} This leads market participants to ask whether there is another proposed rulemaking on the horizon.

Commissioner Quintenz points out that a position limit rule is only one of the tools the CFTC could use to prevent excessive speculation and that the CFTC must ensure that such rules are appropriately tailored within the construct “of the entire regulatory tool kit” to address the price volatility that can be caused by excessive speculation.\textsuperscript{352}

For Commissioner Quintenz, an effective position limit regime would be “built upon two policy platforms. First, the regime must provide commercial market participants and end-users with the reasonable flexibility they need to hedge their risks efficiently – the [CFTC] cannot and should not dictate to commercial firms how they should manage their risk through one-size-fits-all mandate. Second, the position limit rule should not create the potential for additional price volatility risk … by impairing liquidity and impeding price discovery.”\textsuperscript{353} He claims that the most important type of “flexibility” to provide to market participants is the assurance that there are no “unnecessary restrictions or burdens placed [their] ability to engage in bona fide hedging…. [and that the] bona fide hedge [exemption is broad enough to generally encompass legitimate, risk reducing activities.”\textsuperscript{354} He argues further that any “enumerated” bona fide hedge such include common commercial hedging strategies so that market participants have regulatory certainty about the “most basic and frequent hedging methods”\textsuperscript{355} And lastly, he argues, that market participants need an efficient, simple process to receive approval to engage in non-enumerated hedges.\textsuperscript{356}

Commissioner Quintenz calls for the CFTC to examine further its definition of “risk” to mean only “price risk.” He argues that the CFTC’s definition of risk must be broadened to include operational risk, liquidity risk, credit risk, political risk and seasonal risks, so that commercial firms may hedge appropriately.\textsuperscript{357}


\textsuperscript{352}Id.

\textsuperscript{353}Id.

\textsuperscript{354}Id.

\textsuperscript{355}Id.

\textsuperscript{356}Id.

\textsuperscript{357}Id.
The purpose of the enumerated bona fide hedge is to provide regulatory certainty and reduce administrative burdens to market participants.\textsuperscript{358} Therefore, Commissioner Quintenz calls upon the CFTC amend its position limit rules to broaden the list of enumerated bona fide hedges, including the inclusion of a presumption of hedging until the activity is proven to otherwise be speculative.\textsuperscript{359} In a practical manner, Commissioner Quintenz claims that the CFTC regulations cannot be expected to account for all forms of legitimate commercial hedging.\textsuperscript{360} Therefore, he calls for an improvement to the CFTC 2016 Proposed Rule process in order to reduce the burdensome process for market participants seeking a non-enumerated bona fide hedge exemption.\textsuperscript{361} Additionally, he argues that the ability of the CFTC to overturn an exchange determination of a bona fide hedge, at any time, is problematic for market participants.\textsuperscript{362} He believes this too should be amended to allow market participants the ability to rely on these exchange determinations in good faith.\textsuperscript{363}

Given the comments by Commissioner Quintenz and similar comments by Commissioner Dawn Stump\textsuperscript{364}, there does not seem to be a conclusion the position limit rule making process to in the near future.

\textsuperscript{358}Id.
\textsuperscript{359}Id.
\textsuperscript{360}Id.
\textsuperscript{361}Id.
\textsuperscript{362}Id.
\textsuperscript{363}Id.

On October 1, 2018, Chairman Giancarlo of the Commodity Futures Trading Commission ("CFTC" or "Commission") released a white paper titled “Cross-Border Swaps Regulation Version 2.0: A Risk-Based Approach with Deference to Comparable Non-U.S. Regulation.” The Chairman previewed both his views on cross-border swaps reform and the paper itself in speeches delivered in London, Tokyo and Singapore in September.

The white paper provides extensive background on the current regulatory regime for cross-border swaps while also listing a number of adverse consequences of the current approach. The paper outlines the foundations of contemplating swaps reform, principles that should be adhered to when constructing a new architecture for swaps regulation and finally concrete recommendations for rule revisions. This article summarizes the trends and themes from the white paper itself but also the remarks Chairman Giancarlo has delivered on this topic.

The Principals Emphasize Deference

Despite following a similar structure to Chairman Giancarlo’s aforementioned speeches the white paper differs from the previous remarks in a few respects. The speeches set forth five principles to which cross-border swaps reform should adhere. The paper sets forth six principles adding that the “current division of global swaps markets into separate U.S. person and non-U.S.
person marketplaces” should end. Further, “markets in regulatory jurisdictions that have adopted the G20 swaps reform should each function as a unified marketplace, under one set of comparable trading rules and under one competent regulator.”

The justification provided for these principles and the white paper overall was that fragmentation of the “global swaps market means that businesses and commercial enterprises around the globe are denied access to deep, liquid, and consolidated markets” for hedging risks that are “necessary to business expansion, job creation, and economic development.”

The white paper also revised a principle relating to deference. Previously, Chairman Giancarlo stated, “the CFTC should act with deference towards comparable swaps reform regulation in non-U.S. markets by adopting a flexible, outcomes-based approach for substituted compliance.” The white paper states, “the CFTC should act with deference to non-U.S. regulators in jurisdictions that have adopted comparable G20 swaps reforms, seeking stricter comparability for substituted compliance for requirements intended to address systemic risk and more flexible comparability for substituted compliance for requirements intended to address market and trading practices.”

The revised principle includes an acknowledgement of those countries that have already implemented reforms — a point that is emphasized throughout the paper — as well as the view that a flexible outcomes-based approach extends to those requirements addressing market trading practices but not to those requirements addressing systemic risk. Overall, the paper noted time and time again that the CFTC’s cross-border overreach might have made sense in 2013 when other G20 regulatory jurisdictions had yet to implement their respective reforms, but not now. Further, the paper emphasized that a risk-based approach to cross-border regulation is optimal.

The theme of deference that is evidenced by the revision of the principles was also present in the speeches Chairman Giancarlo delivered internationally in September — including a mea culpa offered at London Guildhall. Chairman Giancarlo again raised the issue of deference at the 34th Annual FIA Futures and Options Expo in Chicago in October saying, “I want to focus the balance of my remarks this morning on one of the foundational elements of the White Paper: regulatory deference.”

The Chairman notes that deference is very important because in the past the CFTC did not deploy great deference. The paper states, “the CFTC arguably instigated a rift in cross-border swaps cooperation with non-U.S. jurisdictions, particularly Europe, with the CFTC Cross-Border Guidance by imposing CFTC transaction rules on swaps traded by U.S. persons, even in jurisdictions committed to implementing the G20 swaps reforms.” The paper is reflective of a broader goal of greater deference to regulators in comparable jurisdictions while also asserting authority (and exclusive authority) over activity in the U.S. market. A fact that is obvious in reviewing the concrete recommendations put forth with respect to trades that are arranged, negotiated or executed (“ANE”) within the borders of the U.S, which is the topic of the next section.

The Recommendations and ANE transactions
The recommendations put forth in Chairman Giancarlo’s speeches prior to the release of the white paper centered around non-U.S. central counterparties, non-U.S. trading venues and Non-U.S. swap dealers. As a result, the proposals surrounding these topics were well-previewed and as expected by market participants. The Chairman’s thoughts on ANE transactions were less expected.

The paper put forth a territorial approach to U.S. swaps trading activity, stating trades “arranged, negotiated, or executed” within the United States by personnel or agents of non-U.S. persons are subject to U.S. rules. Put another way, if a swap is executed in the United States, even between two non-U.S. persons, then U.S. swap execution rules (including clearing and trade execution) apply. This view is in furtherance of the principle of “one consolidated marketplace, one set of comparable trading rules and one competent regulator.” The principle is oft-repeated in the white paper and again speaks to the Chairman’s concerns about market fragmentation.

We note that the CFTC staff suggested that ANE transactions should be subject to U.S. transaction-level requirements in 2013. However, implementation of that approach did not come to fruition due to market criticism. The white paper contemplates exceptions to the rule that ANE transactions are subject to U.S. rules regardless of the provenance of the parties involved. The white paper states that ANE transactions should not count towards a non-U.S. entity's swap dealer de minimis threshold if the entity is located in a comparable jurisdiction, as such transactions should not pose a systemic risk to the U.S. financial system.

The white paper also provides two scenarios to clarify the Chairman’s position on ANE transactions. First, if a third-party U.S. intermediary (i.e., an introducing broker) arranges or negotiates swaps among multiple non-U.S. participants then such intermediary should be required to register with the CFTC as a SEF. The justification for such a requirement is that the price formation for the swap occurs within the United States. Chairman Giancarlo connects the first scenario to the white paper he released in April 2018, contending that “rather than achieving the desired outcomes of promoting swaps trading on SEFs and pre-trade transparency, the CFTC’s SEF rules have incentivized the shift of swaps price discovery and liquidity formation away from SEFs to introducing Brokers (IBs).”

Further, “IBs are a regulatory category intended for futures trading,” and as such are not “appropriate vehicles to formulate swaps transactions under the regulatory framework adopted by Congress.” Chairman Giancarlo recommends, instead, swaps to be cleared and all trading activity in the United States — from liquidity formation to trade execution — be conducted on regulated SEFs. This should occur regardless of whether the counterparties are U.S. persons or non-U.S. persons. Chairman Giancarlo’s view of IBs will have significant market impact as an entire registration category will no longer formulate swaps.

The second scenario involves a U.S.-based agent or employee of a non-U.S. swap dealer arranging or negotiating a swap with a non-U.S. person. Chairman Giancarlo posits that the activity of the U.S.-based agent or employee makes the swap subject to CFTC requirements. In the second scenario, Chairman Giancarlo suggests, that in certain cases, deference to a foreign regulator, if the entity is located in a comparable jurisdiction, would be acceptable — again circling back to the theme of deference. Finally the Chairman admits the CFTC staff must
consider the range of ANE transaction situations further in the development of proposed rules. The goal of such rules will be avoiding the fragmentation of the swaps markets within the United States and imposing unnecessary costs on market participants.

Registration of Non U.S. Swap Dealers: Less Onerous Process

Another key component of the white paper are the proposed changes to the registration structure of non-U.S. swap dealers. The paper states, “While it is right to address the risk that non-U.S. swap dealing activity poses to the United States, the CFTC has applied its swap dealer rules extraterritorially without sufficient consideration of whether the activity truly poses a “direct and significant” risk to the U.S. financial system.”

In order to determine the level of risk an entity poses the CFTC has divided non-U.S. swap dealers into three categories: Guaranteed Entities, Foreign Consolidated Subsidiaries (FCS) and Other Non-U.S. Persons. To properly address the risk posed by swap dealers the paper sets forth different rules for when swap dealing transactions count towards an entity’s de minimis threshold and for when they do not.

The key take-away from the new proposal is that fewer entities may have to register as non-U.S. swap dealers, as their activity would not be deemed to pose significant risk to the U.S. financial system. This is a positive outcome as registering as a non-U.S. swap dealer, even when such entity relies on substituted compliance, can be onerous. The process generally requires an gap analysis of regulations to determine whether regulations in the home country jurisdiction are sufficiently comparable to the CFTC regulations. Further, even when the gap analysis is complete it is often the case that the non-U.S. swap dealer ends up adopting a swap dealer policy that wholesale implements CFTC regulations to guard against future regulatory scrutiny.

What Comes Next: New Chairman and Cross-Border

The combination of new commissioners at the CFTC and the possibility of a “hard” Brexit looming ensure it will take some time to implement the proposals put forth in the white paper. The white paper only represents Chairman Giancarlo’s view of a new cross-border approach. The proposals in the paper will be presented to the full Commission for “thoughtful input and bipartisan consideration and adoption.” Then they will need to be transposed into a proposed rule for a full Commission vote and public comment before there can be any changes to the CFTC’s current cross-border construct.

With new Commissioners on board (the Commission has a full slate of members for the first time in four years), who will need time to get up to speed on the substance of the Chairman’s agenda, the timing of the changes Chairman Giancarlo has discussed will not be seen until next year. The resultant rulemakings would replace the cross-border guidance issued in 2013 and the cross-border rules proposed in 2016, as well as address certain positions taken in CFTC staff advisories and no-action letters. However, it is unclear whether Chairman Giancarlo will be able to carry out the principles set forth in the Cross-Border white paper because President Trump has nominated Heath P. Tarbert of Maryland, to be the next Chairman of the CFTC for a five-year
term beginning April 14, 2019. Mr. Tarbert currently serves as Assistant Secretary for International Markets at the Treasury Department.

The upcoming year promises to be active at the CFTC, with a major transition to a new Chairman and across the derivatives markets with the management of the implications of Brexit.
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Deanna Reitman has over 20 years of experience working in commodity markets and more than 8 years of senior management experience. Her background encompasses legal, regulatory and business experience in commodities, with a particular focus on energy. She has extensive global energy commodity legal and regulatory experience.

Deanna is a skilled communicator and team manager with a record of success in achieving complicated objectives. Her core competency is in legal and regulatory global energy commodity marketing and trading, in both physical and financial markets.

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EXPERIENCE

Representative transactions

• Representing U.S. banks, as agent, in million dollar oil and gas warehouse financings
• Representing a U.S. company in a project finance credit facility for the construction and retrofitting of biodiesel facilities
• Representing a U.S. company in its JV with a Chinese entity for the construction and finance of an LNG facility
• Conducting due diligence for U.S. and international companies for the purchase, sale, construction, finance and/or refinancing of upstream, midstream and downstream commodity assets
• Negotiating long term contracts for U.S. and international companies for the operation and service of floating production and storage assets
• Experienced in working with, and advising, petroleum industry clients on operating in the petroleum industry, including upstream matters such as compliance with Mineral Management Services (MMS), mid-stream matters and down-stream matters such as compliance with the Petroleum Marketing Practices Act (PMPA)

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Structuring and negotiating domestic and international physical and financial commodities commercial transactions, including crude, products, natural gas, coal, RINs, RECs, metals and carbon credits in the United States, Latin America, the Caribbean and United Kingdom.

Structuring and negotiating international transactions for the purchase and sale of commodity feedstock to support company assets, which includes the creation of hedging strategies and the negotiation of the agreements to implement such hedging strategies.

Negotiating terms for domestic and international commodities infrastructure projects, including Eagle Ford drilling projects, terminal and pipeline projects in United States, Europe and Latin America.

Negotiating domestic electricity purchase, sale and transmission contracts.

Futures, options, commodities derivatives trading and regulation.

Assisting, in both a legal and business capacity, in the development, creation and implementation of startup global natural gas, crude and product marketing and trading firm.

Negotiating physical energy trading and commercial contracts, including waterborne, rail, truck and pipeline movements.

Negotiating storage and transportation contracts for oil, oil products, natural gas, coal.

Negotiating refining, processing, tolling, and cleaning agreements for oil, oil products, natural gas, coal.

Negotiating storage subleases, assignments, and repos.

Developing Global regulatory compliance programs for energy trading (physical and financial), wholesale and retail.

Negotiating settlements to commercial and contractual disputes, including arbitration proceedings.

Advising developers, sponsors, investors and governments in the negotiation and structure of financing for both domestic and international energy projects.

Represented a large international oil and gas company in a trade finance master participation agreement with Citigroup.

Represent a large international oil and gas company in developing a form master participation agreement for trade finance with institutional banks.

Represent a syndicate of banks in several trade finance facilities with a large South American pulp producer.

Represent a trading firm in several repurchase agreements for the sale of crude oil accounts receivables.

Represent a trading firm in an repurchase agreement for the sale of crude oil accounts receivable from a South American national oil company.
PUBLICATIONS

• $1.2B order entered against Petroleos de Venezuela: Q&As for PDVSA and Citgo commodity commercial and trading counterparties, 25 Sep 2018

• Co-Author, "The Blockchain Energy Commodity Transaction Lifecycle," POWER Magazine, March 4, 2018
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Vice President, Government & Industry Affairs, Bunge North America (2002)
Commissioner, Commodity Futures Trading Commission (CFTC) (1999)
Director, Office of Legislative & Intergovernmental Affairs, CFTC (1997)
Assistant to the President/Counsel, National Grain Trade Council (1990)
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William F. McCoy

William F. McCoy is a Managing Director and Counsel in the Legal and Compliance Department of Morgan Stanley, as well as General Counsel and Secretary of Morgan Stanley Capital Group Inc., a dealer of commodities, commodity derivatives and currency options. He advises Morgan Stanley in connection with its futures, fixed income and commodities market making activities, including its activities involving metals, oil liquids, natural gas, electricity and emissions. He has continuously served as the senior commodities attorney at Morgan Stanley since joining the firm in 1993. Prior to joining Morgan Stanley, Bill served as Vice President & Assistant General Counsel of Metallgesellschaft Corp. (1991-1993), Vice President & Counsel of Manufacturers Hanover Trust Company (1986-1991) and Attorney in the Enforcement & Compliance Division of The U.S. Office of the Comptroller of the Currency (1984-1986). Bill is a member of the Board of Directors of the National Futures Association and serves on a number of its committees. Bill is a member of the Executive Committee of the Futures Industry Association’s Law & Compliance Division and has previously served as the President of that Division (2002-2004) and as a member of the FIA’s Board of Directors (various terms between 2004 and 2007). He has also served as a member of the U.S. Treasury Department’s Bank Secrecy Act Advisory Group (2003-2007) and as a member of the U.S. Commodity Futures Trading Commission’s Energy Markets Advisory Committee and its reconstituted Energy and Environmental Markets Advisory Committee (various terms beginning in 2008). Bill received a B.S. in Economics (1981) from the Wharton School of Business and Economics at The University of Pennsylvania and a J.D. (1984) from Fordham University School of Law.
David S. Mitchell is co-head of Fried Frank's Derivatives Practice and a member of the Corporate Department, resident in the New York office. He joined the Firm in 2006 as a partner.

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Mr. Mitchell is a frequent speaker and author on the topics of derivatives, futures and securities regulation. His writings have appeared in a wide array of well-known publications, such as Futures & Derivatives Law Report, Journal of Investment Compliance, The Review of Securities and Commodities Regulation and The Handbook of Currency and Interest Rate Risk Management.

Mr. Mitchell is consistently recognized by Chambers Global: The World’s Leading Lawyers for Business and Chambers USA: America’s Leading Lawyers for Business as a leading individual in Capital Markets: Derivatives: Debt & Equity and is consistently recognized by Legal 500 in Finance: Structured Finance (Leading Lawyer).

He serves on the Board of Editors of the Futures & Derivatives Law Report. Mr. Mitchell is a member of the American Bar Association, the New York City Bar Association and the New York State Bar Association.

Mr. Mitchell received his LLM from New York University School of Law in 1980, and his JD, magna cum laude, from New York Law School in 1979, where he was a member of the Law Review. He received his BA, summa cum laude, from The City College of New York of The City University of New York in 1976, where he was a member of the Phi Beta Kappa society. Mr. Mitchell is admitted to the bar in New York.
Deanna Reitman has over 20 years of experience working in commodity markets and more than 8 years of senior management experience. Her background encompasses legal, regulatory and business experience in commodities, with a particular focus on energy. She has extensive global energy commodity legal and regulatory experience.

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**EXPERIENCE**

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• Experienced in working with, and advising, petroleum industry clients on operating in the petroleum industry, including upstream matters such as compliance with Mineral Management Services (MMS), mid-stream matters and down-stream matters such as compliance with the Petroleum Marketing Practices Act (PMPA)

• Structuring and negotiating domestic and international physical and financial commodities commercial transactions, including crude, products, natural gas, coal, RINs, RECs, metals and carbon credits in the United States, Latin America, the Caribbean and United Kingdom

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• Advising developers, sponsors, investors and governments in the negotiation and structure of financing for both domestic and international energy projects

PUBLICATIONS

• Co-Author, "The Blockchain Energy Commodity Transaction Lifecycle," *POWER Magazine*, March 4, 2018
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