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COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 1, 15, 17, 19, 32, 37, 38, 140, and 150

RIN 3038-AD99

Position Limits for Derivatives

AGENCY: Commodity Futures Trading Commission.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Commission proposes to amend regulations concerning speculative position limits to conform to the Wall Street Transparency and Accountability Act of 2010 ("Dodd-Frank Act") amendments to the Commodity Exchange Act ("CEA" or "Act"). The Commission proposes to establish speculative position limits for 28 exempt and agricultural commodity futures and option contracts, and physical commodity swaps that are "economically equivalent" to such contracts. In connection with establishing these limits, the Commission proposes to update some relevant definitions; revise the exemptions from speculative position limits, including for bona fide hedging; and extend and update reporting requirements for persons claiming exemption from these limits. The Commission proposes appendices that would provide guidance on risk management exemptions for commodity derivative contracts in excluded commodities permitted under the proposed definition of bona fide hedging position; list core referenced futures contracts and commodities that would be substantially the same as a commodity underlying a core referenced futures contract for purposes of the proposed definition of basis contract; describe and analyze fourteen fact patterns that would satisfy the proposed definition of bona fide hedging position; and present the proposed speculative position

limit levels in tabular form. In addition, the Commission proposes to update certain of its rules, guidance and acceptable practices for compliance with Designated Contract Market ("DCM") core principle 5 and Swap Execution Facility ("SEF") core principle 6 in respect of exchange-set speculative position limits and position accountability levels.

DATES: Comments must be received on or before [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: You may submit comments, identified by RIN number 3038-AD99 by any of the following methods:

- Agency Web site: http:// comments.cftc.gov.
- Mail: Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581.
- Hand Delivery/Courier: Same as mail above.
- Federal eRulemaking Portal: http://www.regulations.gov. Follow instructions for submitting comments.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to www.cftc.gov. You should submit only information that you wish to make available publicly. If you wish the Commission to consider information that is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the procedure established in § 145.9 of the Commission's regulations (17 CFR 145.9).

The Commission reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse, or remove any or all of your submission from

http://www.cftc.gov that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

FOR FURTHER INFORMATION CONTACT: Stephen Sherrod, Senior Economist, Division of Market Oversight, at (202) 418–5452, ssherrod@cftc.gov; Riva Spear Adriance, Senior Special Counsel, Division of Market Oversight, at (202) 418–5494, radriance@cftc.gov; David N. Pepper, Attorney-Advisor, Division of Market Oversight, at (202) 418–5565, dpepper@cftc.gov, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581.

SUPPLEMENTARY INFORMATION:

Table of Contents

I. Position Limits for Physical Commodity Futures and Swaps
- A. Background
  - 1. CEA section 4a
  - 2. The Commission construes CEA section 4a(a) to mandate that the Commission impose position limits
  - 3. Necessity finding
- B. Proposed Rules
  - 1. Section 150.1 — Definitions
    - i. Various definitions found in § 150.1
    - ii. Bona fide hedging definition
  - 2. Section 150.2 — Position limits
    - i. Current § 150.2
    - ii. Proposed § 150.2
  - 3. Section 150.3 — Exemptions
    - i. Current § 150.3
    - ii. Proposed § 150.3
  - 4. Part 19 — Reports by persons holding bona fide hedge positions pursuant to § 150.1 of this chapter and by merchants and dealers in cotton
    - i. Current part 19
    - ii. Proposed amendments to part 19

5. § 150.7 — Reporting requirements for anticipatory hedging positions
i. Current § 1.48
ii. Proposed § 150.7
6. Miscellaneous regulatory amendments
i. Proposed § 150.6 – Ongoing responsibility of DCMs and SEFs
ii. Proposed § 150.8 – Severability
iii. Part 15 – Reports – General provisions
iv. Part 17 – Reports by reporting markets, futures commission merchants, clearing members, and foreign brokers

II. Revision of Rules, Guidance, and Acceptable Practices Applicable to Exchange-Set Speculative Position Limits — § 150.5

A. Background

B. The Current Regulatory Framework for Exchange-Set Position Limits

1. Section 150.5

2. The Commodity Futures Modernization Act of 2000 caused Commission § 150.5 to become guidance on and acceptable practices for compliance with DCM core principle 5

3. The CFTC Reauthorization Act of 2008

4. The Dodd-Frank Act Amendments to CEA section 5

i. The Dodd-Frank Act added provisions that permit the Commission to override the discretion of DCMs in determining how to comply with the core principles

ii. The Dodd-Frank Act established a comprehensive new statutory framework for swaps

iii. The Dodd-Frank Act added the regulation of swaps, added core principles for SEFs, including SEF core principle 6, and amended DCM core principle 5

5. Dodd-Frank Rulemaking

i. Amended part 38
ii. Amended part 37
iii. Vacated part 151

C. Proposed Amendments to § 150.5

1. Proposed amendments to § 150.5 to add references to swaps and swap execution facilities

2. Proposed § 150.5(a) — Requirements and acceptable practices for commodity derivative contracts that are subject to federal position limits

3. Proposed § 150.5(b) — Requirements and acceptable practices for commodity derivative contracts that are not subject to federal position limits

III. Related Matters

A. Considerations of Costs and Benefits

1. Background

i. Statutory mandate to consider costs and benefits

2. Section 150.1 – Definitions

i. Bona fide hedging
ii. Rule summary
iii. Benefits and costs

3. Section 150.2 – Limits
    i. Rule summary
    ii. Benefits
    iii. Costs
    iv. Consideration of alternatives
4. Section 150.3 – Exemptions
    i. Rule summary
    ii. Benefits
    iii. Costs
    iv. Consideration of alternatives
5. Section 150.5 – Exchange-set speculative position limits
    i. Rule summary
    ii. Benefits
    iii. Costs
    iv. Consideration of alternatives
6. Section 150.7 – Reporting requirements for anticipatory hedging positions
    i. Benefits and costs
7. Part 19 – Reports
    i. Rule summary
    ii. Benefits
    iii. Costs
    iv. Consideration of alternatives
8. CEA section 15(a)
    i. Protection of market participants and the public
    ii. Efficiency, competitiveness, and financial integrity of markets
    iii. Price discovery
    iv. Sound risk management
    v. Other public interest considerations

B. Paperwork Reduction Act
    1. Overview
    2. Methodology and assumptions
    3. Information provided by reporting entities/persons and recordkeeping duties
    4. Comments on information collection

C. Regulatory Flexibility Act

IV. Appendices

A. Appendix A — Studies relating to position limits reviewed and evaluated by the Commission

I. Position Limits for Physical Commodity Futures and Swaps

A. Background

1. CEA Section 4a

Speculative position limits have been used as a tool to regulate futures markets for over seventy years. Since the Commodity Exchange Act of 1936,[1] Congress has repeatedly expressed confidence in the use of speculative position limits as an effective means of preventing unreasonable and unwarranted price fluctuations.[2]

CEA section 4a, as amended by the Dodd-Frank Act, provides the Commission with broad authority to set position limits. When Congress created the Commission in 1974, it reiterated that the purpose of the CEA was to prevent fraud and manipulation and to control speculation. Later, the Commodity Futures Modernization Act of 2000 ("CFMA") provided a statutory basis for exchanges to use pre-existing position accountability levels as an alternative means to limit the burdens of excessive speculative positions. Nevertheless, the CFMA did not weaken the Commission's authority in CEA section 4a to establish position limits to prevent such undue burdens on interstate commerce.[3] More recently, in the CFTC Reauthorization Act of 2008, Congress gave the Commission expanded authority to set position limits for significant price discovery contracts on exempt commercial markets.[4]

In 2010, the Dodd-Frank Act expanded the Commission's authority to set position limits by amending CEA section 4a(a)(1) to authorize the Commission to establish position limits not just for futures and option contracts, but also for swaps that are economically equivalent to covered futures and options contracts,[5] swaps traded on a

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[1] 7 U.S.C. 1 et seq.

[2] See, e.g., H.R. Rep. No. 421, 74th Cong., lst Sess. 1 (1935); H.R. Rep. No. 624, 99th Cong., 2d Sess. 44 (1986).

[3] See Commodity Futures Modernization Act of 2000, Public Law 106-554, 114 Stat. 2763 (Dec. 21, 2000).

[4] See Food, Conservation and Energy Act of 2008, Public Law 110–246, 122 Stat. 1624 (June 18, 2008).

[5] See infra discussion of economically equivalent.

DCM or SEF, swaps that are traded on or subject to the rules of a DCM or SEF, and swaps not traded on a DCM or SEF that perform or affect a significant price discovery function with respect to regulated entities ("SPDF Swaps").[6] CEA section 4a(a)(1) further declares the Congressional determination that: "[e]xcessive speculation in any commodity under contracts of sale of such commodity for future delivery made on or subject to the rules of contract markets or derivatives transaction execution facilities, or swaps that perform or affect a significant price discovery function with respect to registered entities causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce in such commodity."[7]

As described below, amended CEA section 4a(a)(2), Congress directed, i.e., mandated, that the Commission "shall" establish limits on the amount of positions, as appropriate, that may be held by any person in agricultural and exempt commodity futures and options contracts traded on a DCM.[8] Similarly, as described below, in amended CEA section 4a(a)(5),[9] Congress mandated that the Commission impose position limits on swaps that are economically equivalent to the agricultural and exempt commodity derivatives for which it mandated position limits in CEA section 4a(a)(2).

With respect to the position limits that the Commission is required to set, CEA section 4a(a)(3) guides the Commission in setting the level of those limits by providing several criteria for the Commission to address, namely: (i) to diminish, eliminate, or

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[6] CEA section 4a(a)(1) (as amended 2010) ; 7 U.S.C. 6a(a)(1).

[7] Id.

[8] CEA section 4a(a)(2); 7 U.S.C. 6a(a)(2).

[9] CEA section 4a(a)(5); 7 U.S.C. 6a(a)(5).

prevent excessive speculation as described under this section; (ii) to deter and prevent market manipulation, squeezes, and corners; (iii) to ensure sufficient market liquidity for bona fide hedgers; and (iv) to ensure that the price discovery function of the underlying market is not disrupted.[10]

CEA section 4a(a)(5) requires the Commission to establish, at an appropriate level, position limits for swaps that are economically equivalent to those futures and options that are subject to mandatory position limits pursuant to CEA section 4a(a)(2).[11] CEA section 4a(a)(5) also requires that the position limits on economically equivalent swaps be imposed at the same time as mandatory limits are imposed on futures and options.[12]

CEA section 4a(a)(6) requires the Commission to apply position limits on an aggregate basis to contracts based on the same underlying commodity across: (1) contracts listed by DCMs; (2) with respect to foreign boards of trade ("FBOTs"), contracts that are price-linked to a contract listed for trading on a registered entity and made available from within the United States via direct access; and (3) SPDF Swaps.[13]

Furthermore, under new CEA section 4a(a)(7), Congress gave the Commission authority to exempt persons or transactions from any position limits it establishes.[14]

2. <u>The Commission construes CEA section 4a(a) to mandate that the Commission impose position limits</u>

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[10] CEA section 4a(a)(3); 7 U.S.C. 6a(a)(3).
[11] CEA section 4a(a)(5); 7 U.S.C. 6a(a)(5).
[12] <u>See id.</u>
[13] CEA section 4a(a)(6); 7 U.S.C. 6a(a)(6).
[14] CEA section 4a(a)(7); 7 U.S.C. 6a(a)(7).

The Commission concludes that, based on its experience and expertise, when section 4a(a) of the Act is considered as an integrated whole, it is reasonable to construe that section to mandate that the Commission impose position limits. This mandate requires the Commission to impose limits on futures contracts, options, and certain swaps for agricultural and exempt commodities. The Commission also concludes that the mandate requires it to impose such limits without first finding that any such limit is necessary to prevent excessive speculation in a particular market.

In ISDA v. CFTC,[15] the district court concluded that section 4a(a)(1) of the Act "unambiguously requires that, prior to imposing position limits, the Commission find that position limits are necessary to 'diminish, eliminate, or prevent' the burden described in [section 4a(a)(1) of the Act]."[16] But the court further concluded that, even if CEA section 4a(a)(1) standing alone required the Commission to make a necessity determination as a prerequisite to imposing position limits, it was plausible to conclude that sections 4a(a)(2), (3), and (5) of the Act, which were added by Dodd-Frank, constituted a mandate, requiring the Commission to impose position limits without making any findings of necessity. The court ultimately determined that the Dodd-Frank amendments, and their relationship to section 4a(a)(1) of the Act, are "ambiguous and lend themselves to more than one plausible interpretation."[17] Thus, the court rejected the Commission's contention that section 4a(a) of the Act unambiguously mandated the imposition of position limits without any finding of necessity.

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[15] International Swaps and Derivatives Association v. United States Commodity Futures Trading Commission, 887 F. Supp. 2d 259 (D.D.C. 2012).

[16] Id. at 270.

[17] Id. at 281.

Having concluded that section 4a(a) of the Act is ambiguous, the court could not rely on the Commission's interpretation to resolve the section's ambiguity. As the court observed, the D.C. Circuit has held that "'deference to an agency's interpretation of a statute is not appropriate when the agency wrongly believes that interpretation is compelled by Congress.'"[18] The court further held that, pursuant to the law of the D.C. Circuit, it was required to remand the matter to the Commission so that it could "fill in the gaps and resolve the ambiguities."[19] The court cautioned the Commission that, in resolving the ambiguity of section 4a(a) of the Act, "'it is incumbent upon the agency not to rest simply on its parsing of the statutory language.'"[20]

The Commission now undertakes the task assigned by the court: using its experience and expertise to resolve the ambiguity the district court perceived in section 4a(a) of the Act. The most important guidepost for the Commission in resolving the ambiguity is section 4a(a)(2) of the Act. That section, which is captioned "Establishment of Limitations," includes two sections that are critical to understanding congressional intent. Subsection 4a(a)(2)(A) provides that the Commission, in accordance with the standards set forth in section 4a(a)(1) of the Act, shall establish limits on the amount of positions, as appropriate, other than bona fide hedge positions that may be held by any person with respect to physical commodities other than excluded commodities.[21] Subsection 4a(a)(2)(B) provides that for exempt commodities, the limits "required" under subsection 4a(a)(2)(A) be established within 180 days of the enactment

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[18] Id. at 280-82, quoting Peter Pan Bus Lines, Inc. v. Fed. Motor Carrier Safety Admin., 471 F.3d 1350, 1354 (D.C. Cir. 2006).

[19] 887 F. Supp. 2d at 282.

[20] Id. at n.7, quoting PDK Labs. Inc. v. DEA, 362 F.3d 786, 797 (D.C. Cir. 2004).

[21] CEA section 4a(a)(2)(A); 7 U.S.C. 6a(a)(2)(A).

of section 4a(a)(2)(B) and that for agricultural commodities, the limits "required" under subsection 4a(a)(2)(A) be established within 270 days of the enactment of section 4a(a)(2)(B).[22]

The court concluded that this section was ambiguous as to whether the Commission had a mandate to impose position limits. The court focused on the opening phrase of subsection (A) – "[i]n accordance with the standards set forth in [section 4a(a)(1) of the Act]." The court held that the term "standards" in section 4a(a)(2) of the Act was ambiguous and could refer to the requirement in section 4a(a)(1) of the Act that the Commission impose position limits "as [it] finds are necessary to diminish, eliminate, or prevent" an unnecessary burden on interstate commerce.[23] Thus, the court held that it was plausible that section 4a(a)(2) of the Act required the Commission to make a finding of necessity as a precondition to imposing any position limit. But the court held that it was also plausible that the reference to "standards" did not incorporate such a requirement.

The Commission believes that it is reasonable to conclude from the Dodd-Frank amendments that Congress mandated limits and did not intend for the Commission to make a necessity finding as a prerequisite to the imposition of limits. The Commission's interpretation of its mandate is also based on congressional concerns that arose, and congressional actions taken, before the passage of the Dodd-Frank amendments. During the years leading up to the enactment, Congress conducted several investigations that concluded that excessive speculation accounted for significant volatility and price increases in physical commodity markets. A congressional investigation determined that

[22] CEA section 4a(a)(2)(B); 7 U.S.C. 6a(a)(2)(B).
[23] 887 F. Supp. 2d at 274-76.

prices of crude oil had risen precipitously and that "[t]he traditional forces of supply and demand cannot fully account for these increases."[24] The investigation found evidence suggesting that speculation was responsible for an increase of as much as $20-25 per barrel of crude oil, which was then at $70.[25] Subsequently, Congress found similar price volatility stemming from excessive speculation in the natural gas market.[26] Thus, these investigations had already gathered evidence regarding the impact of excessive speculation, and had concluded that such speculation imposed an undue burden on the economy. In light of these investigations and conclusions, it is reasonable for the Commission to conclude that Congress did not intend for it to duplicate investigations Congress had already conducted, and did not intend to leave it up to the Commission whether there should be federal limits. Instead, Congress set short deadlines for the limits it "required," and directed the Commission to conduct a study of the limits after their imposition and to report to Congress promptly on their effects. Accordingly, the Commission believes that the better reading of the Dodd-Frank amendments, in light of the congressional investigations and findings made, is the Dodd-Frank amendments require the Commission to impose position limits on physical commodity derivatives as opposed to merely reaffirming the preexisting, discretionary authority the Commission has long had to impose limits as it finds necessary. Congress made the decision to

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[24] "The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat," Staff Report, Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, U.S. Senate, S. Prt. No. 109-65 at 1 (June 27, 2006).

[25] Id. at 12; see also "Excessive Speculation in the Natural Gas Market," Staff Report, Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, U.S. Senate at 1 (June 25, 2007) available at http://www.levin.senate.gov/imo/media/doc/supporting/2007/PSI.Amaranth.062507.pdf (last visited Mar. 18, 2013) ("Gas Report").

[26] Gas Report at 1-2.

impose limits, and it is for the Commission to carry that decision out, subject to close congressional oversight.

Based on its experience, the Commission concludes that Congress could not have contemplated that, as a prerequisite to imposing limits, the Commission would first make the sort of necessity determination that the plaintiffs in ISDA v. CFTC argue section 4a(a)(2) of the Act requires – i.e., a finding that, before imposing any limit in any particular market, there is a reasonable likelihood that excessive speculation will pose a problem in that market, and that position limits are likely to curtail that excessive speculation without imposing undue costs.[27] As the district court noted, for 45 years after passage of the CEA, the Commission's predecessor agency made findings of necessity in its rulemakings establishing position limits.[28] During that period, the Commission had jurisdiction over only a limited number of agricultural commodities. The court cited several orders issued by the Commodity Exchange Commission ("CEC") between 1940 and 1956 establishing position limits, and in each of those orders, the CEC stated that the limits it was imposing were necessary. Each of those orders involved no more than a small number of commodities. But it took the CEC many months to make those findings. For example, in 1938, the CEC imposed position limits on six grain products.[29] Proceedings leading up to the establishment of the limits commenced more than 13 months earlier, when the CEC issued a notice of hearings regarding the limits.[30] Similarly, in September 1939, the CEC issued a Notice of Hearing with respect to

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[27] See 887 F. Supp. 2d at 273.

[28] Id. at 269.

[29] See 3 FR 3145, Dec. 24, 1938.

[30] See 2 FR 2460, Nov. 12, 1937.

position limits for cotton, but it was not until August 1940 that the CEC finally promulgated such limits.[31] And the CEC began the process of imposing limits on soybeans and eggs in January 1951, but did not complete the process until more than seven months later.[32]

In the Commission's experience (i.e., in the experience of its predecessor agency), it took at least four months to make a necessity finding with respect to one commodity. The process of making the sort of necessity findings that plaintiffs urged upon the court with respect to all agricultural commodities and all exempt commodities would be far more lengthy than the time allowed by section 4a(a)(3) of the Act, i.e., 180 or 270 days.

Dodd-Frank requires the Commission to impose position limits on all exempt commodities within 180 days after enactment, and on all agricultural commodities within 270 days.[33] Because of these stringent time limits, the Commission concludes that Congress did not intend for the Commission to delay the imposition of limits until it has first made antecedent, contract-by-contract necessity findings.[34]

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[31] See 4 FR 3903, Sep. 14, 1939; 5 FR 3198, Aug. 28, 1940.

[32] See 16 FR 321, Jan. 12, 1951; 16 FR 8106, Aug. 16, 1951; see also 17 FR 6055, Jul. 4, 1952 (notice of hearing regarding proposed position limits for cottonseed oil, soybean oil, and lard); 18 FR 443, Jan. 22, 1953 (orders setting limits for cottonseed oil, soybean oil, and lard); 21 FR 1838, Mar. 24, 1956 (notice of hearing regarding proposed position limits for onions), 21 FR 5575, Jul. 25, 1956 (order setting position limits for onions).

[33] Although the Commission did not meet these deadlines in its first position limits rulemaking, it completed the task (in which the Commission received and addressed more than 15,000 comments) as expeditiously as possible under the circumstances.

[34] Even if there were no mandate, the Commission would not need to make the sort of particularized necessity findings advocated by the plaintiffs in ISDA v. CFTC, and discussed by the district court. When the Commission imposed limits pre-Dodd-Frank, it only had to determine that excessive speculation is harmful to the market and that limits on speculative positions are a reasonable means of preventing price disruptions in the marketplace that place an undue burden on interstate commerce. That is the determination that the Commission made in 1981 when it required the exchanges to establish position limits on all futures contracts, regardless of the characteristics of a particular contract market. See 46 FR50940 ("[I]t is the Commission's view that this objective ["the prevention of large and/or abrupt price movements which are attributable to extraordinarily large speculative positions"] is enhanced by speculative position limits since it appears that the capacity of any contract market to absorb the

Additional experience of the Commission confirms this interpretation. The Commission has found, historically, that speculative position limits are a beneficial tool to prevent, among other things, manipulation of prices. Limits do so by restricting the size of positions held by noncommercial entities that do not have hedging needs in the underlying physical markets. In other words, markets that have underlying physical commodities with finite supplies benefit from the protections offered by position limits. This will be discussed further, below.

For example, in 1981, the Commission, acting expressly pursuant to, inter alia, what was then CEA Section 4a(1) (predecessor to CEA section 4a(a)(1)), adopted what was then § 1.61.[35] This rule required speculative position limits for "for each separate type of contract for which delivery months are listed to trade" on any DCM, including "contracts for future delivery of any commodity subject to the rules of such contract market."[36] The Commission explained that this action was necessary in order to "close the existing regulatory gap whereby some but not all contract markets [we]re subject to a specified speculative position limit."[37] Like the Dodd-Frank Act, the 1981 final rule established (and the rule release described) that such limits "shall" be established according to what the Commission termed "standards."[38] As used in the 1981 final rule and release, "standards" meant the criteria for determining how the required limits would

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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 the immediate wake of that decision, Congress enacted legislation to give the Commission the specific authority to enforce those omnibus limits. See CEA section 4a(e); 7 U.S.C. 6a(e).

[35] 46 FR 50938, 50944-45, Oct. 16, 1981. The rule adopted in 1981 tracked, in significant part, the language of Section 4a(1). Compare 17 CFR 1.61(a)(1) (1982) with 7 U.S.C. 6a(1) (1976).

[36] 46 FR 50945.

[37] Id. 50939; see also id. 50938 ("to ensure that each futures and options contract traded on a designated contract market will be subject to speculative position limits").

[38] Compare id. at 50941-42, 50945 with 7 U.S.C. 6a(a)(2)(A).

be set.[39] "Standards" did not include the antecedent judgment of whether to order limits at all. The Commission had already made the antecedent judgment in the rule that "speculative limits are appropriate for all contract markets irrespective of the characteristics of the underlying market."[40] It further concluded that, with respect to any particular market, the "existence of historical trading data" showing excessive speculation or other burdens on that market is not "an essential prerequisite to the establishment of a speculative limit."[41] The Commission thus directed the exchanges to set limits for all futures contracts "pursuant to the . . . standards of rule 1.61[.]"[42] And § 1.61 incorporated the standards from then-CEA-section 4a(1) – an "Aggregation Standard" (46 FR at 50943) for applying the limits to positions both held and controlled by a trader and a flexibility standard, allowing the exchanges to set "different and separate position limits for different types of futures contracts, or for different delivery months, or from exempting positions which are normally known in the trade as 'spreads, straddles or arbitrage' or from fixing limits which apply to such positions which are different from limits fixed for other positions."[43]

The language that ultimately became section 737 of the Dodd-Frank Act, amending CEA section 4a(a), originated in substantially final form in H.R. 977, introduced by Representative Peterson, who was then Chairman of the House Agriculture Committee and who would ultimately be a member of the Dodd-Frank conference

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[39] 46 FR 50941-42, 50945.

[40] Id. at 50941.

[42] Id. at 50942.

[43] Id. at 50945 (§1.61(a)). Compare 7 U.S.C. 6a(1) (1976).

committee.[44] H.R. 977 appears influenced by the Commission's 1981 rulemaking, establishing that there "shall" be position limits in accordance with the "standards" identified in CEA section 4a(a).[45] Like the 1981 rule, H.R. 977 established (and the Dodd-Frank Act ultimately adopted) a "good faith" exception for positions acquired prior to the effective date of the mandated limits.[46] The committee report accompanying H.R. 977 described it as "Mandat[ing] the CFTC to set speculative position limits" and the section-by-section analysis stated that the legislation "requires the CFTC to set appropriate position limits for all physical commodities other than excluded commodities."[47] This closely resembles the omnibus prophylactic approach the Commission took in 1981, when the Commission required the establishment of position limits on all futures contracts according to "standards" it borrowed from CEA section 4a(1), and the Commission finds the history and interplay of the 1981 rule and Dodd-Frank section 737 to be further evidence that Congress intended to follow much the same approach as the Commission did in 1981, mandating position limits as to all physical commodities.[48]

Consistent with this interpretation, which is based on the Commission's experience, CEA section 4a(a)(2)(A)'s phrase "[i]n accordance with the standards set forth in [CEA section 4a(a)(1)]" does not require a finding of necessity as a prerequisite to the imposition of position limits, but rather has a different meaning. Section 4a(a)(1)

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[44] H.R. 977, 11th Cong. (2009).

[45] 7 U.S.C. 6.

[46] Compare H.R. 977, 11th Cong. (2009) with 46 FR 50944.

[47] H.Rept. 111-385, at 15, 19 (Dec. 19, 2009).

[48] See Union Carbide Corp. & Subsidiaries v. Comm'r of Internal Revenue, 697 F.3d 104, (2d Cir. 2012) (explaining that when an agency must resolve a statutory ambiguity, to do so "'with the aid of reliable legislative history is rational and prudent'" (quoting Robert A. Katzman, Madison Lecture: Statutes, 87 N.Y.U. L. Rev. 637, 659 (2012)).

of the Act lists "standards" that the Commission must consider, and has historically considered, when it imposes position limits. It contains an aggregation standard, which provides that, if one person controls the positions of another, or if those persons coordinate their trading, then those positions must be aggregated. And it contains a flexibility standard, providing the Commission with the flexibility to impose different position limits for different commodities, markets, delivery months, etc.[49] Because the Commission concludes that, when Congress amended section 4a(a) of the Act and directed the Commission to establish the "required" limits, it did not want, much less require the Commission to make an antecedent finding of necessity for every position limit it imposes, the "standards" the Commission must apply in imposing the limits required by section 4a(a)(2) of the Act consist of the aggregation standard and the flexibility standard of CEA section 4a(a)(1), the same standards the Commission required the exchanges to apply the last time there was a mandatory, prophylactic position limits regime.[50]

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[49] In its 1981 rulemaking in which the Commission required exchanges to impose position limits, the Commission interpreted the term "standards," to not require exchanges to make any finding of necessity with respect to imposing position limits. See 46 FR. 50941-42 (preamble), 50945 (text of § 1.61(a)(2)).

[50] The District Court expressed concern that, unless CEA section 4a(a)(2) incorporated a necessity finding, then the language referring to such a finding in CEA section 4a(a)(1) might be rendered surplusage. 887 F. Supp. 2d at 274–75. That is, the court believed that, unless a necessity finding were incorporated into any limits required by CEA section 4a(a)(2), then the "finds as necessary" language would serve no purpose in the CEA. But there is no surplusage because CEA section 4a(a) only mandates position limits with respect to physical commodity derivatives (i.e., agricultural commodities and exempt commodities). The mandate does not apply to excluded commodities (i.e., intangible commodities such as interest rates, exchange rates, or indexes, see CEA section 1a(19) (defining the term "excluded commodity"). As a result, although a necessity finding does not apply with respect to physical commodities as to which the Dodd-Frank Congress mandated position limits, it still applies to any limits the Commission may choose to impose with respect to excluded commodities. Thus, the mandate of CEA section 4a(a) does not render the necessity language surplusage.

In addition, section 719 of the Dodd-Frank Act (codified at 15 U.S.C. 8307) provides that the Commission "shall conduct a study of the effects (if any) of the position limits imposed" pursuant to CEA section 4a(a)(2), that "[w]ithin 12 months after the imposition of position limits," the Commission "shall" submit a report of the results of that study to Congress, and that, within 30 days of the receipt of that report, Congress "shall" hold hearings regarding the findings of that report. As explained above, if, as a precondition to imposing position limits, the Commission were required to make the sort of necessity determinations apparently contemplated by the district court, the Commission would have to conduct time-consuming studies and then determine as a matter of discretion whether a limit was necessary. The Commission believes that, to comply with section 719 of the Dodd-Frank Act, the Commission would then, within one year, have to conduct another round of studies with respect to each contract as to which it had imposed limits. The Commission does not believe that Congress would have imposed such burdensome and duplicative requirements on the Commission. Moreover, Congress would not have required the Commission to conduct a study of the effects, "if any," of position limits, and would not have imposed a hearing requirement on itself, if the Commission had the discretion to not impose any position limits at all.[51]

Further, Congress was careful to make clear that its mandate only extends to agricultural and exempt commodities. If there were no mandate, then the same standards

[51] When Congress requires an agency to promulgate a rule, it frequently requires the agency to provide it with a report regarding the impact of that rule. See, e.g., 15 U.S.C. 6502, 6506 (provisions of the Children's Online Privacy Protection Act, requiring the FTC to promulgate implementing rules, and to report as to the impact thereof); 47 U.S.C. 227(b), (h) (requiring the FCC to implement rules restricting unsolicited fax advertising, and to report on enforcement); 15 U.S.C. 78m(p) (requiring the SEC to issue rules requiring disclosures regarding the use of certain "conflict minerals" obtained from the Democratic Republic of Congo), and section 1502(d) of the Dodd-Frank Act (requiring the Comptroller General to report regarding the effectiveness of the conflict minerals rule).

that apply to position limits for excluded commodities would also apply to agricultural and exempt commodities and, basically, the Commission would have only permissive authority to promulgate position limits for any commodity—the same permissive authority that existed prior to the Dodd-Frank Act. Finding that a mandate exists is the only way to give effect to the distinction that Congress drew.

The legislative history of the Dodd-Frank amendments to CEA section 4a(a) confirms that Congress intended to make position limits mandatory for agricultural and exempt commodities. As initially introduced, the House version of the bill that became Dodd-Frank provided the Commission with discretionary authority to issue position limits by stating that the Commission "may" impose them.[52] However, by the time the bill passed the House, it dispensed with the permissive approach in favor of a mandate, stating that the Commission "shall" impose limits, and in addition, the House added two new subsections, mandating the imposition of limits for agricultural and exempt commodities with the tight deadlines described above.[53] Similarly, it was only after the initial bill was amended to make position limits mandatory that the House bill referred to the limits for agricultural and exempt commodities as "required" in one instance.[54] Furthermore, Congress decided to include the requirement that the Commission conduct studies on the "effects (if any) of position limits imposed"[55] to determine if the required

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[52] Initially, the House used the word "may" to permit the Commission to impose aggregate positions on contracts based upon the same underlying commodity. See H.R. 4173, 11th Cong. section 3113(a)(2) (as introduced in the House, Dec. 2, 2009) ("Introduced Bill"); see also Brief of Senator Levin et al as Amicus Curiae at 10-11, ISDA v. CFTC, no. 12-5362 (D.C. Cir. Apr. 22, 2013), Document No. 1432046 (hereafter "Levin Br.").

[53] Levin Br. at 11 (citing H.R. 4173, 111th Cong. section 3113(a)(5)(2), (7) (as passed by the House Dec. 11, 2009) ("Engrossed Bill")).

[54] Id. at 12. (citing Engrossed Bill at section 3113(a)(5)(3)).

[55] 15 U.S.C. 8307.

position limits were harming US markets only after position limits went from discretionary to mandatory.[56] To remove all doubt, the House Report accompanying the House Bill also made clear that the House amendments to the position limits bill "required" the Commission to impose limits.[57] The Conference Committee adopted the provisions of the House bill with regard to position limits and then strengthened them by referring to the position limits as "required" an additional three times so that CEA section 4a(a), as enacted referred, to position limits as "required" a total of four times.[58]

Considering the text, purpose and legislative history of section 4a(a) as a whole, along with its own experience and expertise, the Commission believes that it is reasonable to conclude that Congress – notwithstanding the ambiguity the district court found to arise from some of the words in the statute – decided that position limits were necessary with respect to physical commodities, mandated the Commission to impose them on physical commodities, and required that the Commission do so expeditiously.[59]

3. Necessity finding

As explained above, the Commission concludes that the CEA mandates the imposition of speculative position limits. Because of this mandate, the Commission need not make a prerequisite finding that such limits are necessary "to diminish, eliminate or

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[56] See Levin Br. at 13-17; see also DVD: October 21, 2009 Business Meeting (House Agriculture Committee 2009), ISDA v. CFTC, Dkt. 37-2 Exh. B (Apr. 13, 2012) at 59:55 – 1:02:18.

[57] Levin Br. at 23 (citing H.R. Rep. No. 111-373 at 11 (2009)).

[58] Levin Br. at 17-18.

[59] The district court noted that CEA sections 4a(a)(2), (3), and (5)(A) contain the words "as appropriate." The court held that it was ambiguous whether those words referred to the Commission's obligation to impose limits (i.e., the Commission shall, "as appropriate," impose limits), or to the level of the limits the Commission is to impose. Because, as explained above, the Commission believes it is reasonable to interpret CEA section 4a(a) to mandate the imposition of limits, the words "as appropriate" must refer to the level of limits, i.e., the Commission must set limits at an appropriate level. Thus, while Congress made the threshold decision to impose position limits on physical commodity futures and options and economically equivalent swaps, Congress at the same time delegated to the Commission the task of setting the limits at levels that would maximize Congress' objectives. See CEA sections 4a(a)(3)(A)-(B).

prevent excessive speculation causing sudden or unreasonable fluctuations or unwarranted changes in the prices of" commodities under pre-Dodd-Frank CEA section 4a(a)(1). Nonetheless, out of an abundance of caution in light of the district court decision in ISDA v. CFTC, and without prejudice to any argument the Commission may advance in any forum, the Commission proposes, as a separate and independent basis for the proposed Rule, a preliminary finding herein that such limits are necessary to achieve their statutory purposes.[60]

Historically, speculative position limits have been one of the tools used by the Commission to prevent, among other things, manipulation of prices. Limits do so by restricting the size of positions held by noncommercial entities that do not have hedging needs in the underlying physical markets. By capping the size of speculative positions, limits lessen the likelihood that a trader can obtain a large enough position to potentially manipulate prices, engage in corners or squeezes or other forms of price manipulation. The position limits in this proposal are necessary as a prophylactic measure to lessen the likelihood that a trader will accumulate excessively large speculative positions that can result in corners, squeezes, or other forms of manipulation that cause unwarranted or unreasonable price fluctuations. In the Commission's experience, position limits are also necessary as a prophylactic measure because excessively large speculative positions may cause sudden or unreasonable price fluctuations even if not accompanied by manipulative

[60] The CEA does not define "excessive speculation." But the Commission has historically associated it with extraordinarily large speculative positions. 76 FR at 71629 (referring to "extraordinarily large speculative positions").

conduct. Two examples that inform the Commission's determinations are the silver crisis of 1979-80 and events in the natural gas markets in 2006.[61]

Position limits would help to deter and prevent manipulative corners and squeezes, such as the silver price spike caused by the Hunt brothers and their cohorts in 1979-80.

A market is "cornered" when an individual or group of individuals acting in concert acquire a controlling or ownership interest in a commodity that is so dominant that the individual or group of individuals can set or manipulate the price of that commodity.[62] In a short squeeze, an excess of demand for a commodity together with a lack of supply for that commodity forces the price of that commodity upward. During a short squeeze, individuals holding short positions, i.e., sales for future delivery of a commodity,[63] are typically forced to purchase that commodity in situations where the price increases rapidly, in order to exit their short position and/or cover,[64] i.e., be able to deliver the commodity in accordance with the terms of the sale.[65]

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[61] Since the 1920's, Congressional and other official governmental investigations and reports have identified other instances of sudden or unreasonable fluctuations or unwarranted changes in the price of commodities. See discussion below.

[62] See CFTC Glossary, A Guide to the Language of the Futures Industry ("CFTC Glossary"), available at http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary, which defines a corner as "(1) [s]ecuring such relative control of a commodity that its price can be manipulated, that is, can be controlled by the creator of the corner; or (2) in the extreme situation, obtaining contracts requiring the delivery of more commodities than are available for delivery."

[63] See CFTC Glossary, which defines a "short" as "(1) [t]he selling side of an open futures contract; (2) a trader whose net position in the futures market shows an excess of open sales over open purchases."

[64] See CFTC Glossary, which defines "cover" as "(1) [p]urchasing futures to offset a short position (same as Short Covering); . . . (2) to have in hand the physical commodity when a short futures sale is made, or to acquire the commodity that might be deliverable on a short sale" and offset as "[l]iquidating a purchase of futures contracts through the sale of an equal number of contracts of the same delivery month, or liquidating a short sale of futures through the purchase of an equal number of contracts of the same delivery month."

[65] See CFTC Glossary, which defines a "squeeze" as "[a] market situation in which the lack of supplies tends to force shorts to cover their positions by offset at higher prices."

A rapid rise and subsequent sharp decline in silver prices occurred from the second half of 1979 to the first half of 1980 when the Hunt brothers[66] and colluding syndicates[67] attempted to corner the silver market by hoarding silver and executing a short squeeze. Prices deflated only after the Commodity Exchange, Inc. ("COMEX") and the Chicago Board of Trade ("CBOT") imposed a series of emergency rules imposing at various times position limits, increased margin requirements, and trading for liquidation only on U.S. silver futures. It was the consensus view of staffs of the Commission, the Board of Governors of the Federal Reserve System, the Department of the Treasury and the Securities and Exchange Commission articulated in an interagency task force study of events in the silver market during that period that "[r]easonable speculative position limits, if they had been in place before the buildup of large positions occurred, would have helped prevent the accumulation of such large positions and the resultant dislocations created when the holders of those positions stood for delivery."[68] That is, speculative position limits would have helped to prevent the buildup of the silver price spike of 1979-80. The Commission believes that this conclusion remains correct. "Moreover, by limiting the ability of one person or group to obtain extraordinarily large positions, speculative limits diminish the possibility of accentuating price swings if large

[66] The primary silver traders in the Hunt family were Nelson Bunker Hunt, William Herbert Hunt, and Lamar Hunt.

[67] A group of individuals and firms trading through ContiCommodity Services, Inc. and ACLI International Commodity Services, Inc., both of which were FCMs.

[68] Commodity Futures Trading Commission, Report To The Congress In Response To Section 21 Of The Commodity Exchange Act, May 29, 1981, Part Two, A Study of the Silver Market, at 173 ("Interagency Silver Study").

positions must be liquidated abruptly in the face of adverse price movements or for other reasons."[69]

The Hunt brothers were speculators[70] who neither produced, distributed, processed nor consumed silver. The corner began in early 1979, when the Hunt brothers accumulated large physical holdings of silver by purchasing silver futures and taking physical delivery of silver.[71] By the fall of 1979, they had accumulated over 43 million ounces of physical silver.[72] In addition to their physical holdings, in the fall of 1979 the Hunts and their cohorts held over 12 thousand contracts for March delivery, representing a potential future delivery to the hoard of another 60 million ounces of silver.[73] In general, the larger a position held by a trader, the greater is the potential that the position may affect the price of the contract. Throughout late 1979, the Hunts continued to stand for delivery and took care to ensure that their own holdings were not re-delivered back to them when outstanding futures contracts settled.[74] Thus, through this period, silver prices

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[69] Speculative Position Limits, 45 FR 79831, 79833, Dec. 2, 1980.

[70] Speculators seek to profit by anticipating the price movement of a commodity in which a futures position has been established. See CFTC Glossary, which defines a speculator as, "[i]n commodity futures, a trader who does not hedge, but who trades with the objective of achieving profits through the successful anticipation of price movements." In contrast, a hedger is "[a] trader who enters into positions in a futures market opposite to positions held in the cash market to minimize the risk of financial loss from an adverse price change; or who purchases or sells futures as a temporary substitute for a cash transaction that will occur later. One can hedge either a long cash market position (e.g., one owns the cash commodity) or a short cash market position (e.g., one plans on buying the cash commodity in the future)." The Hunts had no apparent industrial use for silver, although some attribute their early activities in the silver market to an attempt to hedge against Carter-era inflation and a defense against potential confiscation of precious metals in the event of a national crisis.

[71] Typically, delivery occurs in only a small percentage of futures transactions. The vast majority of contracts are liquidated by offsetting transactions.

[72] See, e.g., Matonis, Jon, Hunt Brothers Demanded Physical Silver Delivery Too, available at http://www.rapidtrends.com/hunt-brothers-demanded-physical-silver-delivery-too/. To provide context, at this time COMEX and CBOT warehouses held 120 million ounces of silver.

[73] Interagency Silver Study at 18.

[74] It has been reported that they moved vast quantities of silver to warehouses in Switzerland to prevent this possibility.

climbed as the Hunts accumulated more financial and physical positions and the available supply of silver decreased. As the interagency working group observed, "[t]he biggest single source of the change in demand for silver bullion during the last half of 1979 and the first quarter of 1980 came from the silver acquisitions of Hunt family members and other large traders."[75]

The exchanges and regulators were slow to react to events in the silver market. However, to correct by then evident market imbalances, in late 1979 the CBOT introduced position limits of 3 million ounces of silver (i.e., 600 contracts) per trader and raised margin requirements. Contracts over 3 million ounces were to be liquidated by February of 1980. On January 7, 1980, the larger COMEX instituted position limits of 10 million ounces of silver (i.e., 2,000 contracts) per trader, with contracts over that amount to be liquidated by February 18. Then, on January 21, COMEX suspended trading in silver and announced that it would only accept liquidation orders. The price of silver began to decline. When the price of a commodity starts to move against the cornerer, attempts by the cornerer to sell would tend to fuel a further price move against the cornerer resulting in a vicious cycle of price decline. The Hunts were eventually unable to meet their margin calls and took a huge loss on their positions. The interagency working group concluded that the data relating to the episode "support the hypothesis that the deliveries and potential deliveries to large long participants in the silver futures markets contributed to the rise and fall in silver prices in both the cash and futures markets. The rise appears to have been caused in part by the conversion of silver futures contracts to actual physical silver. The subsequent fall in prices was then exacerbated by

[75] Interagency Silver Study at 77.

the anticipated selling of some of the Hunt's physical silver by FCMs as well as the liquidation of Hunt group and possibly . . . [other large traders'] futures positions."[76]

Figure 1 illustrates the rapid rise and sharp decline in the price of silver during the period in question.[77] In January of 1979, the settlement price of silver was approximately $6.00 per troy ounce. By August, the price had risen to over $9.00, an increase of over 50 percent. Through most of October and November 1979, silver traded within a range of $15.00 - $17.50 per troy ounce. On November 28, the closing price rose above $18.00. In December of 1979, the price rose above $30.00 and continued to climb until mid-January. On January 17, 1980, the closing price of silver reached its apex at $48.70 per troy ounce, more than five times the August price. On January 21, the price declined to $44.00; on January 22 the closing price slid to $34.00 per troy ounce. Through March 7, 1980, silver traded in an approximate range of $30.00 - $40.00 per troy ounce. On March 10, silver closed below $30.00. On March 17 and 18, silver closed below $20.00. After a brief rebound above $22.00, by March 26 the price dropped to $15.80. On March 27, the price of silver hit a low of $10.80 per troy ounce, less than a quarter of the high of $48.70 two months earlier. "After March 28, silver prices stabilized for a while in the $12-$15 range. . . . During April through December 1980, silver prices moved generally in a range between $12 and $20 per ounce."[78]

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[76] Interagency Silver Study at 133.

[77] See CFTC Glossary, which defines "spot price" as "[t]he price at which a physical commodity for immediate delivery is selling at a given time and place." The prompt month is the nearest month to the expiration date of a futures contract.

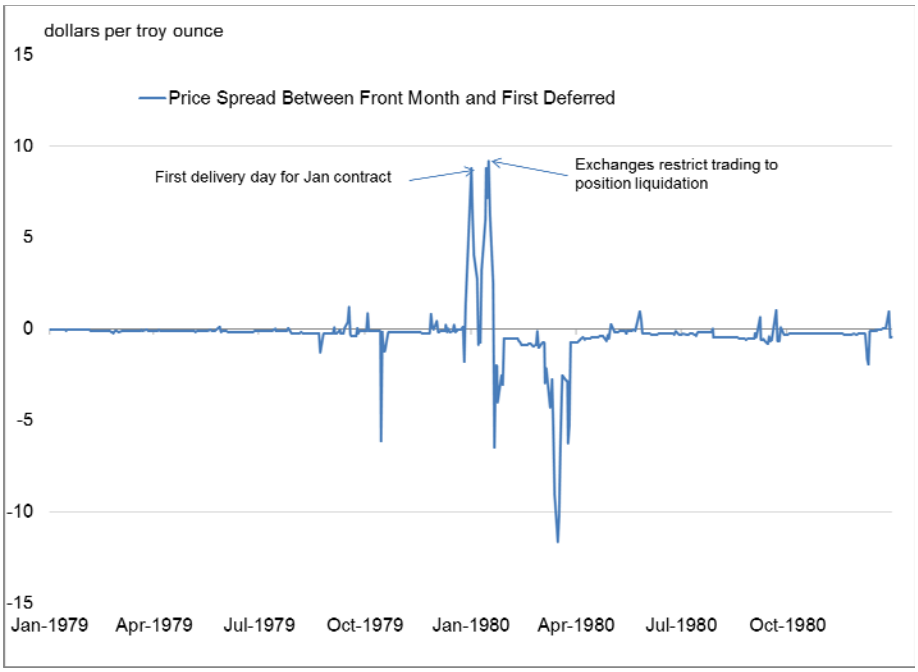
[78] Interagency Silver Study at 35–36.

<u>Figure 1</u>. Silver Prompt Month Prices (Source: Bloomberg)

Figure 2 shows the distortion in the price of silver futures contracts due to the short squeeze during the run-up to the January 17 high and the effect of "burying the corpse" after the squeeze ended. In January 1980, due to the hoarding of the Hunts and their cohorts, physical supplies of silver were tight and the physical commodity was expensive to deliver. Scarcity in the physical market for silver distorted prices in the silver futures markets. The degree to which the value of the front month contract exceeded the value of other contracts was exaggerated. By April of 1980, because the Hunts and their cohorts were forced to sell, physical supply had increased and silver was comparatively cheaper to deliver. The front month contract was then worth substantially less than other contracts. In contrast, assuming equilibrium in production, use, and storage of silver, one would expect the charted price spreads to look comparatively much flatter. That is, there should not be that much difference between the price of the front month contract and other contracts because silver should not be subject to seasonality

such as would affect crops. Moreover, because silver is relatively cheap to store, the difference in the price of the front month and other contracts should also be less sensitive to the cost of carry.

Figure 2. Silver 1st – 2nd Month Futures Spread (Source: Bloomberg)



The Hunt brothers silver episode demonstrates the burdens on interstate commerce of corners and squeezes.

In section 4a(a)(1) of the Act, Congress identifies "sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity"[79] as an indication that excessive speculation may be present in a market for a commodity. The rapid rise and sharp decline in the price of silver that commenced in August 1979 and was spent by the end of March 1980 certainly fits the description advanced by Congress. Nevertheless, the Commission, based on its experience and expertise, does not believe that the burdens on interstate commerce are limited solely to the temporary and unwarranted changes in

[79] 7 U.S.C. 6a(a)(1).

price such as those exhibited during the silver price spike that resulted, at least in part, from the deliberate behavior of the Hunt brothers and their cohorts.[80] Indirect burdens on interstate commerce may arise as a result of unwarranted changes in price such as occurred in this case. Such burdens arise due to manipulation or attempted manipulation, or they may result from the excessive size and disorderly trading of a speculative, i.e., non-hedging, position.

Sudden or unreasonable fluctuations or unwarranted changes in the price of a commodity derivative contract may be caused by a trader establishing, maintaining or liquidating an extraordinarily large position whether in a physical-delivery or cash-settled contract. Prices for commodity derivative contracts reflect expectations about the price of the underlying commodity at a future date and, thus, reflect expectations about supply and demand for that underlying commodity. In contrast, the supply of a commodity derivative contract itself is not limited to the supply of the underlying commodity. Rather, the supply of a commodity derivative contract is a function of the ability of a trader to induce a counterparty to take the opposite side of the transaction.[81] Thus, the capacity of the market (i.e., all participants) to absorb purchase or sale orders for

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[80] The Interagency Silver Study identified three main factors contributing to the price increases in silver at the time.

> First, the state of the economy during the period in question affected all precious metals including silver. . . .
>
> Second, changes in the supply and demand of physical silver affected the price of silver. . . .
>
> Third, the accumulation of large amounts of both physical silver and silver futures by individuals such as the Hunt family of Dallas, Texas, had an effect on the price of silver directly and on the expectations of others who became aware of these actions.

Interagency Silver Study at 2.

[81] In a commodity derivative contract, the two parties to the contract have opposite positions. That is, for every long position in a commodity derivative contract held by one trader, there is a short position that another trader must hold.

commodity derivative contracts is limited by the number of participants that are willing to provide liquidity, i.e., take the other side of the order at a given price. For example, a trader that demands immediacy in establishing a long position larger than the amount of pending offers to sell by market participants may cause the commodity derivative contract price to increase, as market participants may demand a higher price when entering new offers to sell. It follows that an extraordinarily large position, relative to the size of other participants' positions, may cause an unwarranted price fluctuation.

In the spot month for a physical-delivery commodity derivative contract, concerns regarding sudden or unreasonable fluctuations or unwarranted changes in the price of that contract are heighted because open positions in such a contract either: must be satisfied by delivery of the underlying commodity (which is of limited supply and, thus, susceptible to corners or squeezes); or must be offset before delivery obligations attach (that requires trading with another participant to offset the open position).[82] For example, a trader holding an extraordinarily large long position, absent position limits, could maintain a long position (requiring delivery beyond the limited supply of the physical commodity) deep into the spot month. By maintaining such an extraordinarily large position, such a trader may cause an unwarranted increase in the price of the commodity

[82] Regarding cash-settled commodity derivative contracts, there are a variety of methods for determining the final cash settlement price, such as by reference to (i) a survey price of cash market transactions, or (ii) the final (or daily) settlement price of a physical-delivery futures contract. For example, in the case of a trader who holds an extraordinarily large position in a cash-settled contract based on a survey of prices of cash market transactions, where the price of the spot month cash-settled contract is used by cash market participants in determining or setting their cash market transaction prices, then an unwarranted price fluctuation in that cash-settled commodity derivative contract could result in distorted prices in cash market transactions and, thus, an artificial final cash settlement price from a survey of such distorted cash market transaction prices. Alternatively, for example, in the case of a trader who holds an extraordinarily large position in a cash-settled contract based on the final settlement price of a physical-delivery futures contract, then a trader has an incentive to mark the close of that physical-delivery futures contract to benefit her position in the cash-settled contract.

derivative contract, as holders of short positions attempt to induce a counterparty to offset their position.

Prices that deviate from the natural forces of supply and demand, i.e., artificial prices, may occur when there is hoarding of a physical commodity in an attempted or perfected manipulative activity (such as a corner). If a price of a commodity is artificial, resources will be inefficiently allocated during the time that the artificial price exists. Similarly, prices that are unduly influenced by the size of a very large speculative position, or trading that increases or reduces the size of such very large speculative position, may lead to an inefficient allocation of resources to the extent that such prices do not allocate resources to their highest and best use. These burdens were present during the Hunt brothers episode. The Interagency Silver Study concluded that "the volatile conditions in silver markets and the much higher price levels . . . affected the industrial and commercial sectors of the economy to a greater extent than would have been the case if silver price changes had been less turbulent."[83] The Interagency Silver Study described several negative consequences of resource misallocations that occurred during the silver price spike.

Significant changes took place in the use of silver as an industrial input during silver's price oscillation in 1979-80. In the photography industry, the consumption of silver from the first quarter of 1979 to the first quarter of 1980 fell by nearly one third. Similarly, the use of silver in the production of silverware declined by over one half in this period. In addition, numerous other uses of silver exhibited sharp usage declines equivalent to or in excess of these examples. These sharp reductions in silver use are

[83] Id. at 150.

indicative of the general disruption caused by the sharp rise in silver prices. Since the demand for silver in many of these uses is relatively price inelastic, the substantial decline registered in the use of silver for industrial purposes underscores the sizable magnitude of silver price increases and the consequent disruption experienced by the industry.

Individual commercial operations using silver were also disrupted. To illustrate, a major producer of X-ray film discontinued production purportedly as a result of the sharply increased and erratic behavior of the price of silver. In addition, there were reports that trading firms failed financially in early 1980 due to losses incurred in silver markets. Finally, the financial condition of small firms dependent on silver products (hearing aid batteries, printing supplies, etc.) deteriorated as a result of high silver prices and limited supplies.[84]

Moreover, after the settlement price of silver peaked in mid-January 1980, the ensuing "rapid decline of silver prices subjected several FCMs and their parent companies to considerable financial stress."[85] In the view of the Commission and other regulators, "[w]hile all FCMs carrying silver positions appear to have remained solvent during the period in question, the potential for insolvency was significant."[86] The Interagency Silver Study described a cascade of undesirable events;

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[84] Id. (footnotes omitted). James M. Stone, formerly Chairman of the Commission, maintained that the negative effects of the price spike on commercials were borne out in employment figures: "In the case of silver, the employment impacts fell hardest upon the makers of consumer products. According to the Department of Labor's Bureau of Labor Statistics some 6000 jobs in the jewelry, silverware and plateware industries were lost between November of 1979 and February of 1980." Additional Comments on the Interagency Silver Study at 9 ("Stone Comments").

[85] Id. at 135.

[86] Id. at 140.

> Falling prices reduced the equity in the accounts of some large, net long silver futures positions, necessitating margin calls. Responsibility for the financial obligations of some of these positions had to be assumed by FCMs when large margin calls went unmet. A significant proportion of the loans to major silver longs, collateralized by silver, had been made by some FCMs acting for their parent companies. A major portion of this collateral was rehypothecated for bank loans by these companies. The FCMs and their parent companies were thus exposed to two related problems that threatened them with insolvency — the losses on customer accounts and the possibility that silver prices would fall to a point which would cause the banks to demand payment on the hypothecated loans. . . . The FCM was not only vulnerable because of its customers' losses on the futures contracts, but also because of the potential for a decline in the value of loan collateral.[87]

The failure of an FCM with large silver exposures could have adversely affected clients without positions in silver and potentially other participants in the futures markets. The failure of a large FCM could have negatively affected the various exchanges and potentially the clearinghouses.[88] The solvency of FCMs and other Commission registrants crucial to properly functioning futures markets is clearly within the Commission's regulatory ambit. The failure of a commission registrant in the context of unwarranted price spikes would be a burden on interstate commerce.

Fallout from the silver price spike in late 1979-early 1980 extended beyond the silver markets. "Banks, by extending credit for futures market activity while accepting silver as collateral, exposed themselves to higher than normal risks."[89] Unusual activity was also observed in other futures markets, such as precious metals and commodities

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[87] Id. at 135-6 (footnote omitted).

[88] See id. at 140–41. "Although the clearinghouses have contingency plans to deal with insolvent members, to date these plans have covered only the collapse of small FCMs. Conceivably, a major default could result in assessments of members that might, in turn, result in the insolvency of some members and the collapse of the exchange."

[89] Interagency Silver Study at 145. "Bank loans to major silver traders were made both directly and indirectly through FCMs. . . . Default on a major portion of these loans could have had a significant effect on the overall banking industry, but particularly on those banks where the loan concentration was the greatest." Testimony of Philip McBride Johnson, Chairman, Commodity Futures Trading Commission, Before the Subcommittee on Conservation, Credit and Rural Development, Committee on Agriculture, U.S. House of Representatives, Oct. 1, 1981, at 19 ("Johnson Testimony").

other than silver in which the Hunts were thought to have had positions.[90] "On March 27, 1980, the date on which the price of silver dropped to its lowest point, $10.80 an ounce, a combination of factors, including news of the Hunts' problems in meeting margin calls, the efforts of the Hunts to sell positions in various exchange-listed securities in order to meet those calls, and the actions of the SEC in suspending trading in Bache Group stock, appeared to have a direct impact on the securities markets."[91] Commenters noted the marked changes in the rate of inflation concomitant with the rapid rise and fall of the price of silver.[92] Potential bank failures, disruptions in other futures markets, disruptions in the securities markets and volatile inflation rates would be additional burdens on interstate commerce. In highlighting the ability of market participants to accumulate extraordinarily large speculative positions, thereby demoralizing the silver markets to the injury of producers and consumers, the entirety of the Hunt brothers silver episode called into question the adequacy of futures regulation generally and the integrity of the futures markets.

The Commission believes that if Federal speculative position limits had been in effect that correspond to the limits that the Commission proposes now, across markets now subject to Commission jurisdiction, such limits would have prevented the Hunt brothers and their cohorts from accumulating such large futures positions.[93] Such large positions were associated with the sudden fluctuations in price shown in Figures 1 and 2.

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[90] See Interagency Silver Study at 147-8. See also Johnson Testimony at 18-21.

[91] Interagency Silver Study at 148.

[92] See Stone Comments at 9; Johnson Testimony at 20. Contra Philip Cagan, "Financial Futures Markets: Is More Regulation Needed?," I J. Futures Markets 169, 181–82 (1981).

[93] See also Speculative Position Limits, 45 FR 79831, 79833, Dec. 2, 1980 ("Had limits on the amount of total open commitments which any trader or group can own been in effect, such occurrences may have been prevented.").

These unwarranted changes in price imposed an undue and unnecessary burden on interstate commerce, as described in greater detail on the preceding pages. If the Hunt brothers had been prevented from accumulating such large futures positions, they would not have been able to demand delivery on such large futures positions. The Hunts therefore would have been unable to hoard as much physical silver. The Commission's belief is based on the following assessment:

In order to approximate a single-month and all-months-combined limit calculated using a methodology similar to that proposed in this release[94] for silver during this time period, the Commission used data regarding month-end open contracts from the Interagency Silver Study.[95] These month-end open interest reports are for all silver futures combined for the Chicago Board of Trade and the Commodity Exchange in New York.[96] Table 1 shows the month-end open interest for all silver futures combined from August 1979 to April 1980. Using these numbers, the average month-end open interest for this period is 190,545 contracts, and applying the 10, 2.5 percent formula to this average would result in single-month and all-months-combined limits of 6,700 contracts. The Hunts would have exceeded this single-month limit in the fall of 1979 when they and their cohorts held over 12,000 contracts for March delivery.[97] In addition, the Hunts and their cohorts held net positions in silver futures on COMEX and CBOT that exceeded the

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[94] The formula for the non-spot-month position limits is based on total open interest for all Referenced Contracts in a commodity. The actual position limit level will be set based on a formula: 10 percent of the open interest for the first 25,000 contracts and 2.5 percent of the open interest thereafter. The 10, 2.5 percent formula is identified in 17 CFR 150.5(c)(2).

[95] Interagency Silver Study at 117.

[96] During the time of the events discussed, silver bullion futures contracts traded in the United States on the COMEX in New York, the CBOT in Chicago, and the MidAmerica Commodity Exchange ("MCE") in Chicago. At this time, the COMEX and CBOT contracts were each 5,000 troy ounces of silver, and MCE's contract was 1,000 troy ounces. Month-end open interest numbers were not available for MCE.

[97] See discussion below.

calculated all-months-combined limits on multiple occasions between September 1975 and February 1980 as is shown in Table 2. Hence, if the proposed rule had been in place, it could have limited the size of the positions held by the Hunts and their cohorts as early as the autumn of 1975.

There are two limitations to the data used in this analysis. First, the month-end open interest data do not include open interest from the MidAmerica Commodity Exchange. Second, the month-end open interest numbers are for a short time-period starting at the end of August 1979. If the proposed rule had been in place at the time of the Hunt brothers price spike, the limits would have been calculated using data from two years and would likely have used data from an earlier period which could have caused the limit levels to be different. However, the Commission believes that the calculated limits are a fair approximation of the limits that would have applied during this time period. Moreover, for speculative position limits not to have constrained the Hunts at the end of 1975 when their net position was reported as 15,876 contracts, the average total open interest for the time period would have had to be over 500,000 contracts (of 5,000 troy ounces). Moreover, the average total open interest would have had to be over 900,000 contracts (of 5,000 troy ounces) before the all-months-combined limit would have exceeded the maximum net position reported by the Interagency Silver Study (24,722 for September 30, 1979). According to the Interagency Silver Study, it was at this point that the Hunts began acquiring large quantities of physical silver.[98]

[98] Interagency Silver Study at 104.

Table 1. Month-End Open Interest for Chicago Board of Trade (CBOT) and the Commodity Exchange (COMEX), August 1979 through April 1980, All Silver Futures Combined[99]

Date	CBOT Open Interest	COMEX Open Interest	Total Open Interest
8/31/1979	185,031	157,952	342,983
9/30/1979	161,154	167,723	328,877
10/31/1979	105,709	145,611	251,320
11/30/1979	98,009	134,207	232,216
12/31/1979	93,748	127,225	220,973
1/31/1980	49,675	77,778	127,453
2/29/1980	28,211	63,672	91,884
3/31/1980	24,336	48,688	73,024
4/30/1980	19,008	27,166	46,174

Table 2. Estimated Ownership of Silver by Hunt Related Accounts (Contracts of 5,000 Troy Ounc

Date	Net Futures COMEX	Net Futures CBOT	Futures Total (from Tal
9/30/1975	6,917	4,560	**1**
12/31/1975	6,865	9,011	**1**
3/31/1976	6,092	5,324	**1**
6/30/1976	4,061	(920)	
9/30/1976	3,890	578	
12/31/1976	3,910	571	
3/31/1977	3,288	259	
6/30/1977	4,540	816	
9/30/1977	5,277	1,518	
12/31/1977	5,826	2,016	
3/31/1978	6,459	2,224	
6/30/1978	4,200	2,451	
9/30/1978	2,481	3,047	
12/31/1978	4,076	1,317	
3/31/1979	6,655	1,699	
5/31/1979	8,712	4,765	**1**
6/30/1979	9,442	3,846	**1**
7/31/1979	10,407	4,336	**1**

[99] Id. at 117.

[100] Id. at 103.

8/31/1979	14,941	8,700	**2**
9/30/1979	15,392	9,330	**2**
10/31/1979	11,395	7,444	**1**
11/30/1979	12,379	5,693	**1**
12/31/1979	13,806	5,921	**1**
1/31/1980	7,432	1,344	
2/29/1980	6,993	789	
4/2/1980	1,056	388	

The Commission finds that if the position limits suggested by this data were applied as early as 1975, the Hunts would not have been able to accumulate or hold their excessively large futures positions and thereby the limits would have restricted their ability to cause the price fluctuations and other harms described above.

Position limits would help to diminish or prevent unreasonable fluctuations or unwarranted changes in the price of a commodity, such as the extreme price volatility in the 2006 natural gas markets.[101]

Amaranth Advisors L.L.C. ("Amaranth") was a hedge fund that, until its spectacular collapse in September 2006, held "by far the largest positions of any single trader in the 2006 U.S. natural gas financial markets."[102] Amaranth's activities are a

[101] For purposes of discussion, the following section recounts certain findings about the 2006 natural gas markets by the staff of the Permanent Subcommittee on Investigations of the United States Senate (the "Permanent Subcommittee"). See generally Excessive Speculation in the Natural Gas Market, Staff Report with Additional Minority Staff Views, Permanent Subcommittee on Investigations, United States Senate, Released in Conjunction with the Permanent Subcommittee on Investigations, June 25 & July 9, 2007 Hearings ("Subcommittee Report"). Separately, the Commission, on July 25, 2007, charged Amaranth Advisors LLC, Amaranth Advisors (Calgary) ULC and its former head energy trader, Brian Hunter, with attempted manipulation in violation of the Commodity Exchange Act. The charges against the Amaranth entities were later settled, with a fine of $7.5 million levied against them in August of 2009. See U.S. Commodity Futures Trading Commission Charges Hedge Fund Amaranth and its Former Head Energy Trader, Brian Hunter, with Attempted Manipulation of the Price of Natural Gas Futures, July 25, 2007, available at http://www.cftc.gov/PressRoom/PressReleases/pr5359-07; Amaranth Entities Ordered to Pay a $7.5 Million Civil Fine in CFTC Action Alleging Attempted Manipulation of Natural Gas Futures Prices, August 12, 2009, available at http://www.cftc.gov/PressRoom/PressReleases/pr5692-09. The Commission enforcement action is still pending against Brian Hunter. The discussion herein of the natural gas events and Subcommittee Report shall not be construed to alter any statements by or positions of the Commission and its staff in the pending enforcement matter.

[102] Subcommittee Report at 67.

classic example of the market power that often typifies excessive speculation. "Market power" in this context means the ability to move prices by exerting outsize influence on expectations of supply and/or demand for a commodity. Amaranth accumulated such large speculative natural gas futures positions that it affected expectations of demand for physical natural gas and prices rose to levels not warranted by the otherwise natural forces of supply and demand for the commodity.[103]

"Prior to its collapse, Amaranth dominated trading in the U.S. natural gas market. . . . All but a few of the largest energy companies and hedge funds consider trades of a few hundred contracts to be large trades. Amaranth held as many as 100,000 natural gas futures contracts at once, representing one trillion cubic feet of natural gas, or 5% of the natural gas used in the United States in a year. At times, Amaranth controlled up to 40% of all of the open interest on NYMEX for the winter months (October 2006 through March 2007). Amaranth accumulated such large positions and traded such large volumes of natural gas futures that it distorted market prices, widened price spreads, and increased price volatility."[104]

Natural gas is one of the main sources of energy for the United States. The price of natural gas has a pervasive effect throughout the U.S. economy. In general, "[b]ecause one of the major uses of natural gas is for home heating, natural gas demand peaks in the winter month and ebbs during the summer months."[105] During the summer months, when demand for physical natural gas falls, the spot price of natural gas tends to fall, with the excess physical supply being placed into underground storage reservoirs for future use.

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[103] Amaranth was a pure speculator that, for example, could neither make nor take delivery of physical natural gas.

[104] Subcommittee Report at 51–52.

[105] Subcommittee Report at 17.

During the winter, when demand for natural gas exceeds production and the spot price tends to increase, natural gas is removed from underground storage and is consumed.[106]

Amaranth believed that winter natural gas prices would be much higher than summer natural gas prices, notwithstanding an abundant supply of natural gas in 2006. Seeking to profit from this view, Amaranth engaged in spread trading: it bought contracts for future delivery of natural gas in months where it thought prices would be relatively higher and sold contracts for future delivery of natural gas in months were it thought prices would be relatively lower.[107] Amaranth primarily traded the January/November spread and the March/April spread, although it took positions in other near months. When Amaranth bet that the spread between the two contracts would increase, it would make money by selling out of the position or the equivalent underlying legs at a higher price than it paid. Amaranth's positions were extremely large.[108] The Permanent Subcommittee found that "Amaranth's large positions and trades caused significant price movements in key natural gas futures prices and price relationships."[109] The Permanent Subcommittee also found that "Amaranth's trades were not the sole cause

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[106] See id.

[107] Amaranth sought to benefit from changes in the price relationship between two linked contracts. For instance, if a trader is long the front month at 10 and short the back month at 8, the spread is 2. If the price of the front month contract rises to 11, the spread is 3 and the position has a gain. If the price of the back month contract declines to 7, the spread is 3 and the position has a gain. If the price of the front month contract rises to 11 and the price of the back month contract declines to 7, the spread is 4 and the position has a gain. But if the front month contract falls to 8 and the back month contract falls to 6, the spread does not change.

[108] "Amaranth also held large positions in other winter and summer months spanning the five-year period from 2006-2010. In aggregate, Amaranth amassed an extraordinarily large share of the total open interest on NYMEX. During the spring and summer of 2006, Amaranth controlled between 25 and 48% of the outstanding contracts (open interest) in all NYMEX natural gas futures contracts for 2006; about 30% of the outstanding contracts (open interest) in all NYMEX natural gas futures contracts for 2007; between 25 and 40% of the outstanding contracts (open interest) in all NYMEX natural gas futures contracts for 2008; between 20 and 40% of the outstanding contracts (open interest) in all NYMEX natural gas futures contracts for 2009; and about 60% of the outstanding contracts (open interest) in all NYMEX natural gas futures contracts for 2010." Subcommittee Report at 52.

[109] Subcommittee Report at 2.

of the increasing price spreads between the summer and winter contracts; rather they were the *predominant* cause."[110]

Events in the 2006 natural gas markets demonstrate the burdens on interstate commerce of extreme price volatility.

In section 4a(a)(1) of the CEA Congress causally links excessive speculative positions with "sudden or unreasonable fluctuations or unwarranted changes in the price of" such commodities. The precipitous decline in natural gas prices from late-August 2006 until Amaranth's collapse in September 2006 demonstrates that link. The Permanent Subcommittee found that "[p]urchasers of natural gas during the summer of 2006 for delivery in the following winter months paid inflated prices due to Amaranth's speculative trading" and that "[m]any of these inflated costs were passed on to consumers, including residential users who paid higher home heating bills."[111] Such inflated costs are clearly a burden on interstate commerce. In the words of the Permanent Subcommittee, "[t]he Amaranth experience demonstrates how excessive speculation can distort prices of futures contracts that are many months from expiration, with serious consequences for other market participants."[112] The Permanent Subcommittee findings support the imposition of speculative position limits outside the spot month. Commercial participants in the 2006 natural gas markets were reluctant or unable to hedge.[113] Speculators withdrew liquidity from a market viewed as artificially expensive.[114] To relieve the burdens on interstate commerce posed by positions as large as Amaranth's,

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[110] Id. at 68 (emphasis in original).

[111] Id. at 6.

[112] Id. at 4.

[113] See id. at 114.

[114] See id. at 71-77.

Congress directed the Commission to set position limits to, among other things, ensure sufficient market liquidity for bona fide hedgers.[115]

"Amaranth held as many as 100,000 natural gas contracts in a single month, representing 1 trillion cubic feet of natural gas, or 5% of the natural gas in the entire United States in a year. At times Amaranth controlled 40% of all of the outstanding contracts on NYMEX for natural gas in the winter season (October 2006 through March 2007), including as much as 75% of the outstanding contracts to deliver natural gas in November 2008."[116] Position limits that would prevent the accumulation of such overly large speculative positions in deferred commodity contracts would help to prevent unreasonable fluctuations or unwarranted changes in the price of a commodity that may occur when a speculator must substantially reduce its position within a short period of time to the extent the price of such commodity during the unwind period does not reflect fundamental values.[117] Moreover, position limits would help to prevent disruptions to market integrity caused by the corrosive perception that a market is unfair or prices in a market do not reflect the fundamental forces of supply and demand as occurred during 2006 in the natural gas markets. Commodity markets where artificial volatility discourages participation are less likely to produce "a market consensus on correct pricing."[118]

Based on certain assumptions described below, the Commission believes that if Federal speculative position limits had been in effect that correspond to the limits that the

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[115] 7 U.S.C. 6a(a)(3)(B)(iv).

[116] Subcommittee Report at 2.

[117] This is because, among other things, the speculator's influence on expectations of demand is reduced as the speculator is no longer willing and able to hold such a large net position in futures contracts.

[118] Subcommittee Report at 119.

Commission proposes now, across markets now subject to Commission jurisdiction, such limits would have prevented Amaranth from accumulating such large futures positions and thereby restrict its ability to cause unwarranted price effects. Using non-public data reported to the Commission under Part 16 of the Commission's regulations for open interest[119] for natural gas contracts, the Commission calculated the single-month and all-months-combined limits using the same methodology as proposed in this release for the period January 1, 2004 to December 31, 2005. The results of this analysis are presented in Table 3 below, which shows that the resulting single-month and all-months combined limits would have each been 40,900 contracts.

Table 3. Open Interest and Calculated Limits for NYMEX Natural Gas January 1, 2004, to December 31, 2005

Core Referenced Futures Contract	Year	Open Interest (Daily Average)	Open Interest (Month End)	Limit (Daily Average)	Limit (Month End)	Limit
NYMEX Natural Gas	2004	851,763	839,330	23,200	22,900	40,900
	2005	1,559,335	1,529,252	40,900	40,200	

Using non-public data reported to the Commission under Part 17 of the Commission's regulation for large trader positions,[120] the Commission also calculated Amaranth's positions[121] as they would be calculated under the proposed rule for the period January 1, 2005 to September 30, 2006. During this time, Amaranth's net position would have exceeded the limits for the single month and for all-months-combined on

[119] See 17 CFR 16.01.

[120] See 17 CFR 17.00.

[121] Because the Commission's calculations are based on non-public information, the results of this analysis may be different from calculations based on publicly available information, including information contained in the Subcommittee Report.

multiple days, starting as early as June 2006. It is important to note that ICE did not report market open interest for its swap contracts or for large traders to the Commission during this time period, so the Commission cannot exactly replicate the calculations in the proposed rule. However, even if ICE had the same amount of open interest in futures-equivalent terms as all of the NYMEX natural gas contracts listed in 2005,[122] the calculated limit would be 79,900 contracts. According to the Subcommittee Report, Amaranth would have exceeded this limit at the end of July 2006 with its holding of 80,000 long contracts in the January 2007 delivery month.[123] Moreover, the Subcommittee Report also shows that Amaranth tended to trade in the same direction for the same delivery month on ICE and NYMEX. Hence, the Commission believes that had the proposed rule been in effect in 2006, Amaranth would not have been able to build such large positions in natural gas futures and swaps and thereby limits would have restricted Amaranth's ability to cause harmful price effects that limits are intended to prevent.[124]

Position limits would prevent the accumulation of extraordinarily large positions that could potentially cause unreasonable price fluctuations even in the absence of manipulative conduct

As the above examples illustrate, position limits are vital tools to prevent the accumulation of speculative positions that can enable market manipulation. But these

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[122] Since the main natural gas swap contracts on ICE are one quarter of the size of the NYMEX Henry Hub Natural Gas Futures contract, this would mean that the open interest for natural gas contracts on ICE would have to be four times the open interest for natural gas contracts on NYMEX.

[123] See Subcommittee Report at 79.

[124] According to the Subcommittee Report, Amaranth reduced its positions on NYMEX as directed by NYMEX in August 2006, and at the same time, increased its corresponding positions on ICE. See Subcommittee Report at 97-98.

examples also show that limits are necessary to achieve a broader statutory purpose — to prevent price distortions that can potentially occur due to excessively large speculative positions even in the absence of manipulative conduct.

The text of section 4a(a)(1) of the Act itself establishes its broader purpose: it authorizes limits as the Commission finds are necessary to prevent price distortions that can potentially occur due to excessive speculation (i.e. excessively large speculative positions), without regard to whether it is manipulative.[125] The Commission has long interpreted the provision as authorizing limits to achieve this broader purpose and it has long found that limits are necessary to do so.

For example, in the 1981 Rule requiring exchanges to set limits for all commodities, noted above, the Commission found that "historical and current reason for imposing position limits on individual contracts is to prevent unreasonable fluctuations or unwarranted changes in the price of a commodity which may occur by allowing any one trader or group of traders acting in concert to hold extraordinarily large futures positions."[126] In a 2010 rulemaking, the Commission stated that "[f]rom the earliest days of federal regulation of the futures markets, Congress made it clear that unchecked speculative positions, even without intent to manipulate the market, can cause price disturbances. To protect markets from the adverse consequences associated with large speculative positions, Congress expressly authorized the [Commission] to impose speculative position limits prophylactically."[127]

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[125] See 7 U.S.C. 6a(a)(1).

[126] 46 FR 50938, 50939, Oct. 16, 1981.

[127] 75 FR 4144, 4145-46, Jan. 26, 2010.

The Commission reiterated this view before Congress in 1982 in opposing industry amendments to the CEA that would have required that limits are necessary to prevent manipulation, corners or squeezes. Former Commission Chair Philip McBride Johnson told Congress that position limits were "predicated on several different sections of the Commodity Exchange Act which pertain to orderly markets and the terms 'manipulation, corners or squeezes' refer to only one class of market disruption which the limits established under this rule are intended to diminish or prevent. For instance, CEA section 4a contains the Congressional finding that excessive speculation in the futures markets can cause sudden or unreasonable fluctuations or unwarranted changes in the price of commodities. Accordingly, a requirement that the Commission make the suggested finding concerning 'manipulation, corners, or squeezes' prior to requiring a contract market to establish speculative limits could significantly restrict the application of the current rule and undermine its more comprehensive regulatory purpose of preventing excessive speculation which arises from extraordinarily large positions." [128]

Congress effectively ratified the Commission's interpretation in 1982. As it explained: "the Senate Committee decided to retain [CEA section] 4a language concerning the burden which excess speculation places on interstate commerce. This was due to the Committee's belief that speculative limits, in addition to their role in preventing manipulations, corners, or squeezes, are also important regulatory tools for preventing unreasonable fluctuations or unwarranted changes in commodity prices that may arise even in the absence of manipulation."[129]

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[128] Futures Trading Act of 1982: Hearings on S. 2109 before the S. Subcomm. on Agricultural Research, 97th Cong. 44 (1982).

[129] S. Rep. 97-384 at 45 (1982).

The Commission has long found and again finds, based on its experience, that unchecked speculative positions can potentially disrupt markets. In general, the larger a position held by a trader, the greater is the potential that the position may affect the price of the contract. The Commission reaffirms that, "the capacity of any contract 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."[130] When positions exceed the capacity of markets to absorb and liquidate them, unreasonable price fluctuations and volatility can potentially occur. "[B]y limiting the ability of one person or group to obtain extraordinarily large positions, speculative limits diminish the possibility of accentuating price swings if large positions must be liquidated abruptly in the face of adverse price movements or for other reasons."[131] As former Commission Chair McBride Johnson explained to Congress regarding the silver crisis:: "it seems clear from the silver crisis that the orderly imposition of speculative limits before a crisis develops is one of the more promising means of solving such difficulties in the future ...."[132] This statement is equally true of the natural gas events of 2006. Had the Hunt brothers and Amaranth been prevented from amassing extraordinarily large speculative positions in the first place, their ability to cause unwarranted price fluctuations and volatility and other harmful market effects attributable to such positions would have been restricted.

The Commission requests comment on all aspects of this section.

Studies and Reports

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[130] 46 FR 50938, Oct. 16, 1981 (adopting then § 1.61 (now part of § 150.5)).

[131] 45 FR at 79833.

[132] Futures Trading Act of 1982: Hearings on S. 2109 before the S. Subcomm. on Agricultural Research, 97th Cong. 44 (1982).

In addition to those cited previously, the Commission has reviewed and evaluated additional studies and reports (collectively, "studies") about various issues relating to position limits. A list of studies that the Commission has reviewed is in appendix A to this preamble.

Some studies discuss whether or not excessive speculation exists, the definition of excessive speculation, and/or whether excessive speculation has a negative impact on derivatives markets.[133] Those studies that do generally discuss the impact of position limits do not address or provide analysis of how the Commission should specifically implement position limits under section 4a of the CEA.[134] Some studies may be read to support the imposition of Federal speculative position limits; others suggest that speculative position limits will be ineffective; still others assert that imposing speculative position limits will be harmful. There is a demonstrable lack of consensus in the studies.

Many of the studies were focused on the impact of speculative activity in futures markets, e.g., how the behavior of non-commercial traders affected price levels. Such studies did not provide a view on position limits in general or on the Commission's implementation of position limits in particular. Some studies have found little or no evidence of excessive speculation unduly moving prices,[135] while others conclude there is

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[133] 76 FR at 71663.

[134] Id. at 71664.

[135] See, e.g., Harris, Jeffrey and Buyuksahin, Bahattin, "The Role of Speculators in the Crude Oil Futures Market," June 16, 2009, at 2, 19 ("We find that the changing net positions of no specific trader groups lead to price changes …."and "we fail to find the causality from these [speculative] traders' positions to prices."); Byun, Sungje, "Speculation in Commodity Futures Market, Inventories and the Price of Crude Oil," January 17, 2013, at 3, 33 (noting that "… evidence among researchers is inconsistent" but that "we conclude there does not exist sufficient evidence on the potential contribution of financial investors in the crude oil market."); Irwin, Scott H.; Sanders, Dwight R.; and Merrin, Robert P., "Devil or Angel: The Role of Speculation in the Recent Commodity Price Boom," August 1, 2009, at 17 ("There is little evidence that the recent boom and bust in commodity prices was driven by a speculative bubble .... Economic fundamentals, as usual, provide a better explanation for the movements in commodity prices.").

significant evidence of the impact of speculation in commodity markets.[136] Even studies that questioned whether speculation affects prices were often equivocal.[137] Still other studies have determined that while speculation may not cause a price movement, such activity may increase price pressures, thereby exacerbating the price movement.[138]

Several studies did generally address the concept of position limits as part of their discussion of speculative activity. The authors of some of these works expressed views that speculative position limits were an important regulatory tool and that the CFTC

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[136] See, e.g., Singleton, Kenneth J., "Investor Flows and the 2008 Boom/Bust in Oil Prices," March 23, 2011, at 2-3 (Singleton presents "… new evidence that … there were economically and statistically significant effects of investor flows on futures prices."); Tang, Ke and Xiong, Wei, "Index Investment and Financialization of Commodities," November 1, 2012, at 72 ("As a result of the financialization process, the price of an individual commodity is no longer determined solely by its supply and demand. Instead, prices are also determined by the aggregate risk appetite for financial assets and the investment behavior of diversified commodity index investors."); Manera, Matteo, Nicolini, Marcella, and Vignati, Ilaria, "Futures Price Volatility in Commodities Markets: The Role of Short-Term vs Long-Term Speculation," April 1, 2013, at 15 ("We find that speculation significantly affects the volatility of returns, although in contrasting ways. The scalping index has a positive and significant coefficient in the variance equation, suggesting that short term speculation has a positive impact on volatility.").

[137] Compare Technical Committee of the International Organization of Securities Commissions, Task for on Commodity Futures Markets Final Report, March 1, 2009, at 3 ("economic fundamentals, rather than speculative activity, are a plausible explanation for recent price changes in commodities") with id. at 8 ("short term expectations can be influenced by sentiment and investor behavior, which can amplify short-term price fluctuations, as in other asset markets"). Another study opining that speculative activity in general may reduce volatility nevertheless conceded that the authors could not rule out the possibility that a single trader might implement strategies that move prices and increase volatility. Brunetti, Celso and Buyuksahin, Bahattin, "Is Speculation Destabilizing?," April 22, 2009, at 4, 22-23; see also Irwin, et al., "The Performance of CBOT Corn, Soybean, and Wheat Futures Contracts after Recent Changes in Speculative Limits," July 29, 2007, at 1, 6 (concluding that there was "no large change in" price volatility after speculative limits were increased, but cautioning that "[w]ith limited observations available for the period following the change in speculative limits …, conclusions about the impact on volatility are tentative. Additional observations will be required across varying scenarios of supply, demand, and price level, to have full confidence in the conclusions.") (emphasis added); Parsons, John E., "Black Gold & Fool's Gold: Speculation in the Oil Futures Market," September 1, 2009, at 108 (position limits will not prevent asset bubbles from forming, but they are "necessary to insure the integrity of the market").

[138] See, e.g., Hamilton, James D., "Causes and Consequences of the Oil Shock of 2007-08," April 1, 2009, at 258 (Hamilton raises "the possibility that miscalculation of the long-run price elasticity of oil demand … was one factor in the oil shock of 2007-2008, and that speculative investing in oil futures may have contributed to that miscalculation."); Juvenal, Luciana and Petrella, Ivan, "Speculation in the Oil Market," June 1, 2012, ("While global demand shocks account for the largest share of oil price fluctuations, speculative shocks are the second most important driver.").

should implement limits to control excessive speculation.[139] For example, one author opined that ". . . strict position limits should be placed on individual holdings, such that they are not manipulative."[140] Another stated, "[s]peculative position limits worked well for over 50 years and carry no unintended consequences. If Congress takes these actions, then the speculative money that flowed into these markets will be forced to flow out, and with that the price of commodities futures will come down substantially. Until speculative position limits are restored, investor money will continue to flow unimpeded into the commodities futures markets and the upward pressure on prices will remain."[141] The authors of one study claimed that "[r]ules for speculative position limits were historically much stricter than they are today. Moreover, despite rhetoric that imposing stricter limits would harm market liquidity, there is no evidence to support such claims,

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[139] See, e.g., Greenberger, Michael, "The Relationship of Unregulated Excessive Speculation to Oil Market Price Volatility," January 1, 2010, at 11 (On position limits: "The damage price volatility causes the economy by needlessly inflating energy and food prices worldwide far outweighs the concerns about the precise application of what for over 70 years has been the historic regulatory technique for controlling excessive speculation in risk-shifting derivative markets.".); Khan, Mohsin S., "The 2008 Oil Price "Bubble"," August 2009, at 8 ("The policies being considered by the CFTC to put aggregate position limits on futures contracts and to increase the transparency of futures markets are moves in the right direction."); U.S. Senate Permanent Subcommittee on Investigations, "Excessive Speculation in the Wheat Market," June 2009, at 12 ("The activities of these index traders constitute the type of excessive speculation the CFTC should diminish or prevent through the imposition and enforcement of position limits as intended by the Commodity Exchange Act."); U.S. Senate Permanent Subcommittee on Investigations, "Excessive Speculation in the Natural Gas Market," June 25, 2007, at 8 (The Subcommittee recommended that Congress give the CFTC authority over ECMs, noting that "[to] ensure fair energy pricing, it is time to put the cop back on the beat in all U.S. energy commodity markets."); United Nations Conference on Trade and Development, "The Global Economic Crisis: Systemic Failures and Multilateral Remedies," March 1, 2009, at 14, (The UNCTAD recommends that "... regulators should be enabled to intervene when swap dealer positions exceed speculative position limits and may represent 'excessive speculation'.); United Nations Conference on Trade and Development, "The Financialization of Commodity Markets," July 1, 2009, at 26 (The report recommends tighter restrictions, notably closing loopholes that allow potentially harmful speculative activity to surpass position limits.).

[140] de Schutter, Olivier, "Food Commodities Speculation and Food Price Crises," September 1, 2010, United Nations Special Report on the Right to Food, at 8.

[141] Masters, Michael and White, Adam, "The Accidental Hunt Brothers: How Institutional Investors are Driving up Food and Energy Prices," July 31, 2008, at 3.

especially in light of the fact that the market was functioning very well prior to 2000, when speculative limits were tighter."[142]

Not all of the reviewed studies viewed position limits in a positive light. One study claimed that position limits will not restrain manipulation,[143] while another argued that position limits in the agricultural commodities have not significantly affected volatility.[144] Another study noted that while position limits are effective as an anti-manipulation measure, they will not prevent asset bubbles from forming or stop them from bursting.[145] A study cautioned that while limits may be effective in preventing manipulation, they should be set at an optimal level so as to not harm the affected markets.[146] Another study claimed that position limits should be administered by DCMs, as those entities are closest to and most familiar with the intricacies of markets and thus

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[142] Medlock, Kenneth and Myers Jaffe, Amy, "Who is In the Oil Futures Market and How Has It Changed?," August 26, 2009, Baker Institute for Public Policy, at 8.

[143] Ebrahim, Muhammed and Rhys ap Gwilym, "Can Position Limits Restrain Rogue Traders?," March 1, 2013, Journal of Banking & Finance, at 27 (". . . binding constraints have an unintentional effect. That is, they lead to a degradation of the equilibria and augmenting market power of Speculator in addition to other agents. We therefore conclude that position limits are not helpful in curbing market manipulation. Instead of curtailing price swings, they could exacerbate them.").

[144] Irwin, Scott H.; Garcia, Philip; and Good, Darrel L., "The Performance of CBOT Corn, Soybean, and Wheat Futures Contracts after Recent Changes in Speculative Limits," July 29, 2007, at 16 ("The analysis of price volatility revealed no large change in measures of volatility after the change in speculative limits. A relatively small number of observations are available since the change was made, but there is little to suggest that the change in speculative limits has had a meaningful overall impact on price volatility to date.").

[145] Parsons, John E., "Black Gold & Fool's Gold: Speculation in the Oil Futures Market," September 1, 2009, at 30 ("Restoring position limits on all nonhedgers, including swap dealers, is a useful reform that gives regulators the powers necessary to ensure the integrity of the market. Although this reform is useful, it will not prevent another speculative bubble in oil. The general purpose of speculative limits is to constrain manipulation . . . . Position limits, while useful, will not be useful against an asset bubble. That is really more of a macroeconomic problem, and it is not readily managed with microeconomic levers at the individual exchange level.").

[146] Wray, Randall, "The Commodities Market Bubble: Money Manager Capitalism and the Financialization of Commodities," October 1, 2008, at 41, 43 ("While the participation of traditional speculators offers clear benefits, position limits must be carefully administered to ensure that their activities do not "demoralize" markets. . . .The CFTC must re-establish and enforce position limits.").

can implement the most efficient position limits policy.[147] Another study suggested eliminating position limits, arguing that increasing ex-post penalties for manipulation would be more effective at deterring manipulative behavior.[148] One study noted the similar efforts under discussion in European markets.[149]

Studies that militate against imposing any speculative position limits appear to conflict with the Congressional mandate (discussed above) that the Commission impose limits on futures contracts, options, and certain swaps for agricultural and exempt commodities. Such studies also appear to conflict with Congress' determination, codified in CEA section 4a(a)(1), that position limits are an effective tool to address excessive speculation as a cause of sudden or unreasonable fluctuations or unwarranted changes in the price of such commodities.[150]

In any case, these studies overall show a lack of consensus regarding the impact of speculation on commodity markets and the effectiveness of position limits. While there is not a consensus, the fact that there are studies on both sides, in the Commission's

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[147] CME Group, Inc., "Excessive Speculation and Position Limits in Energy Derivatives Markets," CME Group White Paper, at 6 ("Indeed, as the Commission has previously noted, the exchanges have the expertise and are in the best position to fix position limits for their contracts. In fact, this determination led the Commission to delegate to the exchanges authority to set position limits in non-enumerated commodities, in the first instances, almost 30 years ago.")(available at http://www.cmegroup.com/company/files/PositionLimitsWhitePaper.pdf).

[148] Pirrong, Craig, "Squeezes, Corpses, and the Anti-Manipulation Provisions of the Commodity Exchange Act," October 1, 1994, at 2 ("The efficiency of futures markets would be improved, and perhaps substantially so, by eliminating position limits … and relying upon revitalized, harm-based sanctions to deter market manipulation.").

[149] European Commission, "Review of the Markets in Financial Instruments Directive," December 1, 2010, at 82 note 282 ("European Parliament … calls on the Commission to develop measures to ensure that regulators are able to set position limits to counter disproportionate price movements and speculative bubbles, as well as to investigate the use of position limits as a dynamic tool to combat market manipulation, most particularly at the point when a contract is approaching expiry. It also requests the Commission to consider rules relating to the banning of purely speculative trading in commodities and agricultural products, and the imposition of strict position limits especially with regard to their possible impact on the price of essential food commodities in developing countries and greenhouse gas emission allowances.").

[150] 7 U.S.C. 6a(a)(1)-(2).

view, warrants erring on the side of caution. In light of the Commission's experience with position limits, and its interpretation of congressional intent, it is the Commission's judgment that position limits should be implemented as a prophylactic measure, to protect against the potential for undue price fluctuations and other burdens on commerce that in some cases have been at least in part attributable to excessive speculation.

In this regard, the Commission has found two studies of actual market events to be helpful and persuasive in making its alternative necessity finding.[151] The first is the inter-agency report on the silver crisis.[152] This report, by a joint task force of the staffs of the Commission, the Board of Governors of the Federal Reserve System, the Department of the Treasury and the Securities and Exchange Commission, provides an in-depth description and analysis of the silver crisis, the Hunt brothers' build-up of massive positions, the manipulative conduct that those massive positions enabled, the resulting extreme price volatility, and consequent harms to the economy. The second is the PSI Report on Excessive Speculation in the Natural Gas market.[153] As a Congressional report issued following hearings, it is more helpful and persuasive than academic and other studies in indicating how Congress views limits as necessary to prevent the adverse effects of excessively large speculative positions. The PSI Report is also more helpful because it thoroughly studied actual market events involving a vital energy commodity, natural gas, examined how Amaranth's buildup of massive speculative positions by itself

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[151] Another study of actual market events analyzed position limits in the context of the "Flash Crash" of May 6, 2010. While this study concluded that position limits would not have prevented the crash, and that price limits were more effective, it measured the impacts of potential limits on certain financial contracts not implicated in the instant rulemaking. Lee, Bernard; Cheng, Shih-Fen; and Koh, Annie, "Would Position Limits Have Made any Difference to the 'Flash Crash' on May 6, 2010," November 1, 2010, at 37.

[152] U.S Commodity Futures Trading Commission, "Part Two, A Study of the Silver Market," May 29, 1981, Report To The Congress In Response To Section 21 Of The Commodity Exchange Act.

[153] U.S. Senate Permanent Subcommittee on Investigations, "Excessive Speculation in the Natural Gas Market," June 25, 2007.

created a risk of market harms, documented how Amaranth sought to avoid existing limits, and analyzed how its ability to do so was a cause of the attendant extreme price volatility documented in the report.

The Commission requests comment on its discussion of studies and reports. It also invites commenters to advise the Commission of any additional studies that the Commission should consider, and why.

B. Proposed Rules

1. Section 150.1 — Definitions

i. Various definitions found in § 150.1

The Commission proposes to amend the definitions of "futures-equivalent," "independent account controller,'' "long position," "short position," and "spot month" found in § 150.1 of its regulations to conform them to the concepts and terminology of the CEA, as amended by the Dodd-Frank Act.[154] The Commission also is proposing to add to § 150.1, definitions for "basis contract," "calendar spread contract," "commodity derivative contract," "commodity index contract," "core referenced futures contract," "eligible affiliate," "entity," "excluded commodity," "intercommodity spread contract," "intermarket spread positions," "intramarket spread positions," "physical commodity," "pre-enactment swap," "pre-existing position," "referenced contract," "spread contract," "speculative position limit," "swap," "swap dealer" and "transition period swap." In addition, the Commission is proposing to move the definition of bona fide hedging from § 1.3(z) into part 150, and to amend and update it. Moreover, the Commission proposes to delete the definition for "the first delivery month of the 'crop year.'" The Commission

[154] In a separate proposal approved on the same date as this proposal, the Commission is proposing amendments to § 150.4 — aggregation of positions ("Aggregation NPRM") (Nov. 5, 2013), including amendments to the definitions of ''eligible entity" and "independent account controller."

notes that several terms that are not currently in part 150 are not included in the current rulemaking proposal even though definitions for those terms were adopted in vacated part 151. The Commission does not view definition of these terms as necessary for clarity in light of other revisions proposed herein. The terms not currently proposed include "swaption" and "trader."[155] Separately, the Commission is making a non-substantive change to list the definitions in alphabetical order rather than by use of assigned letters. This last change will be helpful when looking for a particular definition, both in the near future, in light of the additional definitions proposed to be adopted, and in the expectation that future rulemakings may adopt additional definitions.

a. <u>Basis contract</u>

While the term "basis contract" is not defined in current § 150.1, a definition was adopted in vacated § 151.1. The definition adopted in § 151.1 defined basis contract as "an agreement, contract or transaction that is cash-settled based on the difference in price of the same commodity (or substantially the same commodity) at different delivery locations." When it adopted part 151, the Commission noted that a swap based on the difference in price of a commodity (or substantially the same commodity) at different delivery locations was a "basis contract and therefore not subject to the limits adopted therein.[156]

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[155] "Swaption" was defined in vacated part 151 to mean "an option to enter into a swap or a physical commodity option." "Trader" was defined in vacated part 151 to mean "a person that, for its own account or for an account that it controls, makes transactions in Referenced Contracts or has such transactions made." The Commission notes that while vacated part 151 and several places in current part 150 use the term "trader," the term "person" is currently used in both § 1.3(z) and in other places in part 150. The amendments in both the Aggregation NPRM and this NPRM use the term "person" in a manner consistent with its current use in part 150.

[156] 76 FR 71626, 71631 (n. 49), Nov. 18, 2011.

Under the proposal, the definition for "basis contract" adopted in § 150.1 would expand upon the definition of basis contract adopted in vacated part 151, by defining basis contract to mean "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 in appendix B to this part as substantially the same as a commodity underlying the same core referenced futures contract."

The Commission notes that the proposal excludes intercommodity spread contracts, calendar spread contracts, and basis contracts from the definition of "commodity index contract."

The Commission is proposing appendix B to this part, Commodities Listed as Substantially the Same for Purposes of the Definition of Basis Contract. The Commission proposes to expand the definition of basis contract to include contracts cash-settled on the difference in prices of two different, but economically closely related commodities. The basis contract definition in vacated part 151 targeted the location differential. Now the Commission is proposing a basis contract definition that would expand to include certain

quality differentials (e.g., RBOB vs. 87 unleaded).[157] The intent of the expanded definition is to reduce the potential for excessive speculation in referenced contracts where, for example, a speculator establishes a large outright directional position in referenced contracts and nets down that directional position with a contract based on the difference in price of the commodity underlying the referenced contracts and a close economic substitute that was not deliverable on the core referenced futures contract. In the absence of this expanded definition, the speculator could then increase further the large position in the referenced contracts. By way of comparison, the Commission preliminarily believes there is greater concern that (i) someone may manipulate the markets by disguise of a directional exposure through netting down the directional exposure using one of the legs of a quality differential (if that quality differential contract were not exempted) than (ii) that someone may use certain quality differential contracts that were exempted from position limits to manipulate the outright price of a referenced contract. Historically, manipulation has occurred though use of outright positions (as in the case of the Hunt brothers) or time spreads (Amaranth, for example, used calendar month spreads), rather than quality or locational differentials.

The Commission seeks comment on alternatives to the specification of quality standards for substantially the same commodity, such as a methodology to identify and define which differential contracts should be excluded from position limits. (i) Should the Commission expand the definition of basis contract to include any commodity priced at a differential to any of its products and by-products? For example, should a basis contract include a soybean crush spread contract or a crude oil crack spread contract,

[157] The expanded basis contract definition is not intended to include significant time differentials in prices of the two commodities (e.g., the expanded basis contract definition would not include calendar spreads for nearby vs. deferred contracts).

regardless of the number of components? (ii) Should the Commission expand the definition of basis contract to include a product or by-product of a particular commodity, priced at a differential to another product or by-product of that same commodity? For example, should the basis contract definition include a contract based on jet fuel priced at a differential to heating oil? Jet fuel and heating oil are both products of the same commodity, namely crude oil. (iii) Should the Commission expand the definition of basis contract for a particular commodity to include other similar commodities? For example, should the basis contract definition include a contract based on the difference in prices of light sweet crude oil and a sour crude oil that is not deliverable on the WTI contract?

b. Commodity derivative contract

The Commission proposes in §150.1(l) to define the term "commodity derivative contract" for position limits purposes as shorthand for any futures, option, or swap contract in a commodity (other than a security futures product as defined in CEA section 1a(45)). Part 150 refers only to futures and options, while vacated part 151 was drafted without the use of any similar concise phrase. It was determined during the process of updating part 150 that the use of such a generic term would be a useful way to streamline and simplify references in part 150 to the various kinds of contracts to which the position limits regime applies. As such, this new definition can be found frequently throughout the Commission's proposed amendments to part 150.[158]

c. Commodity index contract

[158] See, e.g., proposed amendments to § 150.1 (the definitions of: 'basis contract," the definition of "bona fide hedging position," "inter-market spread position," "intra-market spread position," "pre-existing position," "speculative position limits," and "spot month"), §§ 150.2(f)(2), 150.3(d), 150.3(h), 150.5(a), 150.5(b), 150.5(e), 150.7(d), 150.7(f), appendix A to part 150, and appendix C to part 150.

The term "commodity index contract" is not currently defined in § 150.1; a definition for the term was adopted in vacated part 151.[159] Under the definition adopted in § 151.1, 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, a commodity index contract used to circumvent speculative position limits shall be considered to be a Referenced Contract for the purpose of applying the position limits of § 151.4."[160]

The Commission noted in the vacated part 151 final rulemaking that the definition of "Referenced Contract" in § 151.1 expressly excluded commodity index contracts.[161] The Commission also noted that "if a swap is based on prices of multiple different commodities comprising an index, it is a 'commodity index contract.'"[162] As the preamble pointed out, it would not, therefore, be subject to position limits.[163]

The Commission proposes in the current rulemaking to add into § 150.1 substantially the same definition for "commodity index contract" as was adopted in vacated § 151.1, with one change. The proviso included in § 151.1, which required treatment of a position in a commodity index contract as a Referenced Contract if the

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[159] 76 FR at 71685.

[160] See id.

[161] Id. at 71656.

[162] Id. at 71631 n.49.

[163] Id. The Commission clarifies here, that, as was noted in the vacated part 151 Rulemaking, if a swap is based on the difference between two prices of two different commodities, with one linked to a core referenced futures contract price (and the other either not linked to the price of a core referenced futures contract or linked to the price of a different core referenced futures contract), then the swap is an "intercommodity spread contract," is not a commodity index contract, and is a Referenced Contract subject to the position limits specified in § 150.2. The Commission further clarifies that, again as was noted in the vacated part 151 Rulemaking, a contract based on the prices of a referenced contract and the same or substantially the same commodity (and not based on the difference between such prices) is not a commodity index contract and is a referenced contract subject to position limits specified in § 150.2. See id.

contract was used to circumvent speculative position limits, acted in the § 151.1 definition as an anti-evasion provision, a substantive regulatory requirement. Consequently, to provide greater clarity as to the effect of the provision, the definition of "commodity index contract" proposed in 150.1 mirrors that of the definition in 151.1, but with no anti-evasion proviso. Instead, an anti-evasion provision, while similar to that contained in § 151.1, is included in proposed § 150.2(h).[164]

As in vacated part 151, and as noted above, the definition of "referenced contract" proposed in the current rulemaking also expressly excludes commodity index contracts. However, as the Commission noted in the final part 151 Rulemaking, part 20 of the Commission's regulations requires reporting entities to report commodity reference price data sufficient to distinguish between commodity index contract and non-commodity index contract positions in covered contracts.[165] Therefore, for commodity index contracts, the Commission intends to rely on the data elements in § 20.4(b) to distinguish data records subject to § 150.2 position limits from those contracts that are excluded from § 150.2. This will enable the Commission to set position limits using the narrower data set (i.e., referenced contracts subject to § 150.2 position limits) as well as conduct surveillance using the broader data set.

d. Core referenced futures contract

While current part 150 does not contain a definition of the term "core referenced futures contracts," a definition for the term was adopted in vacated § 151.1 as a simple short-hand phrase to denote certain futures contracts, regarding which several position limit rules were then applied. The definition adopted in § 151.1 provided that a core

[164] See discussion below.

[165] 76 FR at 71632.

referenced futures contract was "a futures contract defined in § 151.2"; section 151.2 provided a list of 28 physical commodity futures and option contracts.[166]

The Commission proposes to include in § 150.1 the same definition as was adopted in vacated § 151.1 – such that the definition would cite to futures contracts listed in § 151.2. [167]

e. Eligible affiliate

The term "eligible affiliate," used in proposed § 150.2(c)(2), is not defined in current § 150.1. The Commission proposes to amend § 150.1 to define an "eligible affiliate" as "an entity with respect to which another person: (1) directly or indirectly holds either: (i) a majority of the equity securities of such entity, or (ii) 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 Generally Accepted Accounting Principles or International Financial Reporting Standards, and such consolidated financial statements include the financial results of such entity; and (3) is required to aggregate the positions of such entity under § 150.4 and does not claim an exemption from aggregation for such entity."[168]

The definition of "eligible affiliate" proposed in the current NPRM qualifies persons as eligible affiliates based on requirements similar to those recently adopted by the Commission in a separate rulemaking. On April 1, 2013, the Commission provided relief from the mandatory clearing requirement of section 2(h)(1)(A) of the Act for

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[166] The Commission clarified in adopting § 151.2, that core referenced futures contracts included options that expire into outright positions in such contracts. See 76 FR at 71631.

[167] The selection of the core referenced futures contracts is explained in the discussion of proposed § 150.2. See discussion below.

[168] See proposed § 150.1.

certain affiliated persons if the affiliated persons ("eligible affiliate counterparties") meet requirements contained in § 50.52.[169] Under both § 50.52 and the current proposed definition, a person is an eligible affiliate if the person, directly or indirectly, holds a majority ownership interest in the other counterparty (a majority of the equity securities of such entity, or the right to receive upon dissolution of, or the contribution of, a majority of the capital of such entity), reports its financial statements on a consolidated basis under Generally Accepted Accounting Principles or International Financial Reporting Standards, and such consolidated financial statements include the financial results of such entity. In addition, for purposes of the position limits regime, an eligible affiliate, as proposed in § 150.1, must be required to aggregate the positions of such entity under § 150.4 and does not claim an exemption from aggregation for such entity.[170]

The Commission requests comment on the proposed definition. Is the definition an appropriate one for purposes of the position limits regime? Should the Commission consider adopting a definition that more closely tracks the "eligible affiliate counterparties" definition adopted in § 50.52 or is the difference appropriate in light of the differing regulatory purposes of the two regulations?

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[169] See Clearing Exemption for Swaps Between Certain Affiliated Entities, 78 FR 21749, 21783, Apr. 11, 2013. Section 50.52(a) addresses eligible affiliate counterparty status, allowing a person not to clear a swap subject to the clearing requirement of section 2(h)(1)(A) of the Act and part 50 if the person meets the requirements of the conditions contained in paragraphs (a) and (b) of § 50.52. The conditions in paragraph (a) of § 50.52 specify either one counterparty holds a majority ownership interest in, and reports its financial statements on a consolidated basis with, the other counterparty, or both counterparties are majority owned by a third party who reports its financial statements on a consolidated basis with the counterparties.

The conditions in paragraph (b) of § 50.52 address factors such as the decision of the parties not to clear, the associated documentation, audit, and recordkeeping requirements, the policies and procedures that must be established, maintained, and followed by a dealer and major swap participant, and the requirement to have an appropriate centralized risk management program, rather than the nature of the affiliation. As such, those conditions are less pertinent to the definition of eligible affiliate.

[170] See proposed amendments to the definition of "eligible affiliate" in proposed § 150.1.

f. Entity

The current proposal defines "entity" to mean "a 'person' as defined in section 1a of the Act."[171] The term is not defined in either current § 150.1, but was defined in vacated § 151.1; the language proposed here tracks that adopted in § 151.1. The term "entity," like that of "person," is used in a number of contexts, and in various definitions. Defining the term, therefore, provides a clear and unambiguous meaning, and prevents confusion.

g. Excluded commodity

The phrase "excluded commodity" was added into the CEA in the CFMA, but was not defined or used in part 150. CEA section 4a(a)(2)(A), as amended by the Dodd-Frank Act, utilizes the phrase "excluded commodity" when it provides a timeline under which the Commission is charged with setting limits for futures and option contracts other than on excluded commodities.[172]

Part 151 included in the definition section of vacated § 151.1, a definition which simply incorporated into part 151 the statutory meaning, as a useful term for purposes of a number of the changes made by part 151 to the position limits regime. For example, the phrase was used in vacated § 151.11, in the provision of acceptable practices for DCMs and SEFs in their adoption of rules and procedures for monitoring and enforcing position accountability provisions; it was also used in the amendments to the definition of bona fide hedging.[173] Similarly, the Commission believes that the adoption into part 150

[171] CEA section 1a(38); 7 U.S.C. 1a(38).

[172] CEA section 4a(2)(A); 7 U.S.C. 6a(2)(A).

[173] See 17 CFR 1.3(z) as amended by the vacated part 151 Rulemaking.

of the excluded commodity definition will be a useful tool in addressing the same provisions, and so proposes to adopt into §150.1 the definition used in § 151.1.[174]

h. First delivery month of the crop year

The term "first delivery month of the crop year" is currently defined in § 150.1(c), with a table of the first delivery month of the crop year for the commodities for which position limits are currently provided in § 150.2. The crop year definition has been pertinent for purposes of the spread exemption to the single month limit in current § 150.3(a)(3), which limits spread positions in a single month to a level no more than that of the all-months limit. The Commission did not adopt this definition in vacated part 151.[175] In the current proposal, the Commission proposes to amend § 150.1 to delete the definition of "crop year." The elimination of the definition reflects the fact that the definition is no longer needed, since the current proposal, like the approach adopted in part 151, would raise the level of individual month limits to the level of the all-month limits.

i. Futures equivalent

The term "futures-equivalent" is currently defined in § 150.1(f) to mean "an option contract which has been adjusted by the previous day's risk factor, or delta coefficient, for that option which has been calculated at the close of trading and published by the applicable exchange under § 16.01 of this chapter."[176] The Commission proposes to retain the definition currently found in § 150.1(f), while broadening it in light of the

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[174] See e.g., proposed § 150.1 definitions for bona fide hedging and proposed amendments to § 150.5(b).

[175] See 76 FR at 71685.

[176] 17 CFR 150.1(f).

Dodd-Frank Act amendments to CEA section 4a.[177] The proposed amendments would also delete, as unnecessary, the reference to § 16.01 found in the current definition.

As proposed, "futures equivalent" would be defined in § 150.1 as "(1) 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 open position in a core referenced futures contract."

Vacated § 151.1 did not retain a definition for "futures-equivalent;" instead final part 151 referred to guidance on futures equivalency provided in appendix A to part 20.[178] The Commission notes that while the part 20 "futures equivalent" definition is consistent with the "futures-equivalent" definition proposed herein, it addresses only swaps, and cites to, and relies on, the guidance provided in appendix A to part 20.[179] The definition proposed herein addresses both options on futures and options that are swaps; it also includes and expands upon clarifications that are incorporated into the current

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[177] Amendments to CEA section 4a(1) authorize the Commission to extend position limits beyond futures and option contracts to swaps traded on a DCM or SEF and swaps not traded on a DCM or SEF that perform or affect a significant price discovery function with respect to regulated entities ("SPDF swaps"). 7 U.S.C. 6a(a)(1). In addition, under new CEA sections 4a(a)(2) and 4a(a)(5), speculative position limits apply to agricultural and exempt commodity swaps that are "economically equivalent" to DCM futures and option contracts. 7 U.S.C. 6a(a)(2) and (5).

[178] 76 FR at 71633 (n. 67) (stating that "For purposes of applying the limits, a trader shall convert and aggregate positions in swaps on a futures equivalent basis consistent with the guidance in the Commission's appendix A to Part 20, Large Trader Reporting for Physical Commodity Swaps."). See also 76 FR 43851, 43865, Jul. 22, 2011.

[179] See 17 CFR 20.1 ("Futures equivalent means an economically equivalent amount of one or more futures contracts that represents a position or transaction in one or more paired swaps or swaptions consistent with the conversion guidelines in appendix A of this part.").

definition regarding the computation time and the adjustment by an economically reasonable and analytically supported risk factor, or delta coefficient.

As noted above, the current § 150.1(f) definition of "futures-equivalent" is narrowly defined to mean "an option contract," and nothing else. Although certain contracts, from a practical standpoint, may be economically equivalent to futures contracts, as that terms is defined in § 150.1, such products are not "futures-equivalent" under the narrow definition of current § 150.1(f) unless they are options on those actual futures. Therefore, current § 150.1(f) is narrowly tailored to target only specifically enumerated futures contracts on "legacy" agricultural commodities and their equivalent options.

The current rulemaking, like vacated part 151, establishes federal position limits and limit formulas for 28 physical commodity futures and option contracts, or "core referenced futures contracts," and applies these limits to all derivatives that are directly or indirectly linked to the price of a core referenced futures contracts, or based on 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, and defines such derivative products, collectively, as "referenced contracts." Therefore, the position limits amendments proposed in this current rulemaking, similar to the position limits regime established in vacated part 151, apply across different trading venues to economically equivalent contracts, as that term is defined in § 150.1, that are based on the same underlying commodity. As discussed supra, however, current part 150 defines "futures-equivalent" narrowly to mean "an option contract," and makes no mention of broadly defined "referenced contracts."

Consequently, as noted above, and consistent with these changes to the position limits regime, including the applicability of aggregate position limits to economically equivalent "referenced contracts" across different trading venues, the Commission proposes to expand the strict "futures-equivalent" standard set forth in current part 150.

j. Intercommodity spread contract

Current part 150 does not include a definition of the term "intercommodity spread contract," which was introduced and adopted in vacated part 151. The Commission proposes to add into § 150.1 the definition adopted in § 151.1,[180] such that an "intercommodity spread contract" means "a cash-settled agreement, contract or transaction that represents the difference between the settlement price of a referenced contract and the settlement price of another contract, agreement, or transaction that is based on a different commodity." The Commission determined, however, to adopt the term "intercommodity spread contract" as part of the definition of reference contract rather than as a separate term, since the phrase "intercommodity spread contract" is used solely for purposes of defining the term "referenced contract." The inclusion of the term as part of the definition of referenced contract is intended to simplify the definition section and make it easier to understand.

k. Intermarket spread position

The term "intermarket spread position" is not defined in current part 150, and was not adopted in part 151. But in conjunction with the amendments to part 150 to address

[180] In vacated part 151, ''intercommodity spread contract" was defined to mean "a cash-settled agreement, contract or transaction that represents the difference between the settlement price of a Referenced Contract and the settlement price of another contract, agreement, or transaction that is based on a different commodity." See vacated § 151.1.

the changes to CEA section 4a made by the Dodd-Frank Act,[181] the Commission proposes to add into § 150.1 a definition for "intermarket spread position" to mean "a long position in a commodity derivative contract in a particular commodity at a particular designated contract market or swap execution facility and a short position in another commodity derivative contract in that same commodity away from that particular designated contract market or swap execution facility." Among the changes to CEA section 4a, new section 4a(a)(6) of the Act requires the Commission to apply position limits on an aggregate basis to contracts based on the same underlying commodity across certain markets.[182] The Commission believes that the term "intermarket spread position" simplifies the proposed changes to § 150.5, which provide acceptable exemptions DCMs and SEFs may choose to grant from speculative position limits.[183]

l. Intramarket spread position

Neither current part 150, nor vacated part 151, includes a definition of the term "intramarket spread contract." The Commission now proposes to add into § 150.1 the definition, such that "intramarket spread position" means "a long position in a commodity derivative contract in a particular commodity and a short position in another commodity derivative contract in the same commodity on the same designated contract market or swap execution facility."

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[181] See e.g., discussions of Dodd-Frank changes to CEA section 4a above and below.

[182] CEA section 4a(a)(6) requires the Commission to apply position limits on an aggregate basis to (1) contracts based on the same underlying commodity across DCMs; (2) with respect to foreign boards of trade ("FBOTs"), contracts that are price-linked to a DCM or SEF contract and made available from within the United States via direct access; and (3) SPDF swaps. 7 U.S.C. 6a(a)(6). See also, consideration of proposed changes to § 150.2 for further discussion.

[183] See e.g., § 150.5(a)(2)(B)(ii); see also 150.5(b)(5)(b)(iv).

Current part 150 includes exemptions for certain spread positions. For example, current § 150.3(a)(3) provides an exemption for spread (or arbitrage) positions, but this exemption is limited to those between single months for futures contracts and/or, options thereon, if outside of the spot month, and only if in the same crop year. While current § 150.3(a)(3) limits the spread exemption provided thereunder, the exemption under current § 150.5(a) is not so limited. Instead, under current § 150.5(a), exchanges may exempt from position limits "positions which are normally known in the trade as "spreads, straddles, or arbitrage . . . ."[184] The Commission notes that the definition it now proposes for "intramarket spread position" is a generic term, and not limited only to futures and/or options thereon.[185] In a similar manner to adoption of the term "intermarket spread position," the term "intramarket spread position," therefore, simplifies the Commissions amendments to exemptions for spread positions, including proposed changes to § 150.5, which, as noted above, provide acceptable exemptions DCMs and SEFs may choose to grant from speculative position limits.

m. <u>Long position</u>

The term "long position" is currently defined in § 150.1(g) to mean "a long call option, a short put option or a long underlying futures contract," but the phrase was not retained in vacated § 151.1. The Commission proposes to retain the definition, but to update it to make it also applicable to swaps such that a long position would include a long futures-equivalent swap.

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[184] The Commission notes that the exemption provided in § 150.5(a) for "positions which are normally known in the trade as 'spreads, straddles, or arbitrage,'" tracks CEA section 4a(a)(1). 7 U.S.C. 6a(a)(1). Also, various DCMs currently have rules in place that provide exemptions for such as "spreads, straddles, or arbitrage" positions. <u>See, e.g.</u>, ICE Futures U.S. rule 6.27 and CME rule 559.C.

[185] For further discussion regarding the exemptions for intramarket spread positions, <u>see infra</u>, discussion regarding § 150.5(a)(2) and (b)(5).

n. Physical commodity

The Commission proposes to amend § 150.1 by adding in a definition of the term "physical commodity" for position limits purposes. Congress used the term "physical commodity" in CEA sections 4a(a)(2)(A) and 4a(a)(2)(B) to mean commodities "other than excluded commodities as defined by the Commission." Therefore, the Commission interprets "physical commodities" to include both exempt and agricultural commodities, but not excluded commodities, and proposes to define the term as such.[186]

o. Referenced Contracts

Part 150 currently does not include a definition of the phrase "Referenced Contract," which was introduced and adopted in vacated part 151.[187] As was noted when part 151 was adopted, the Commission identified 28 core referenced futures contracts and proposed to apply aggregate limits on a futures equivalent basis across all derivatives that [met the definition of Referenced Contracts'].",[188]

The vacated § 151.1 definition of Referenced Contracts included: (1) the Core Referenced Futures Contract; (2) "look-alike" contracts (i.e., those that settle off of the Core Referenced Futures Contract and contracts that are based on the same commodity for the same delivery location as the Core Referenced Futures Contract); (3) contracts

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[186] For position limits purposes, proposed § 150.1 would define "physical commodity" to mean "any agricultural commodity as that term is defined in §1.3 of this chapter or any exempt commodity as that term is defined in section 1a(20) of the Act."

[187] Vacated § 151.1 defined "Referenced Contract" to mean "on a futures-equivalent basis with respect to a particular Core Referenced Futures Contract, a Core Referenced Futures Contract listed in § 151.2, or a futures contract, options contract, swap or swaption, other than a basis contract or contract on a commodity index that is: (1) 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; or (2) 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."

[188] 76 FR at 71629.

with a reference price based only on the combination of at least one Referenced Contract price and one or more prices in the same or substantially the same commodity as that underlying the relevant Core Referenced Futures Contract; and (4) intercommodity spreads with two components, one or both of which are Referenced Contracts. According to the Commission, these criteria captured contracts with prices that are or should be closely correlated to the prices of the Core Referenced Futures Contract, as defined in vacated § 151.1.[189] In addition, the definition included categories of Referenced Contract based on objective criteria and readily available data (i.e., derivatives that are directly or indirectly linked to or based on the same commodity for delivery at the same delivery location as a Core Referenced Futures Contract).[190] At that time, the Commission clarified that a swap contract using as its sole floating reference price the prices generated directly or indirectly from the price of a single Core Referenced Futures Contract or a swap priced based on a fixed differential to a Core Referenced Futures Contract, were look-alike Referenced Contracts, and subject to the limits adopted in vacated part 151.[191] In addition, the definition included options that expire into outright positions in such contracts.[192]

In response to comments that the Commission should broaden the scope of Referenced Contracts, the Commission noted that expanding the scope of position limits

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[189] Id. at 71630.

[190] Id. at 71630–31.

[191] Id. at 71631 n.50 ("The Commission has clarified in its definition of 'Referenced Contract' that position limits extend to contracts traded at a fixed differential to a Core Referenced Futures Contract (e.g., a swap with the commodity reference price NYMEX Light, Sweet Crude Oil + $3 per barrel is a Referenced Contract) or based on the same commodity at the same delivery location as that covered by the Core Referenced Futures Contract, and not to unfixed differential contracts (e.g., a swap with the commodity reference price Argus Sour Crude Index is not a Referenced Contract because that index is computed using a variable differential to a Referenced Contract).").

[192] Id. at 71631.

based, for example, on cross-hedging relationships or other historical price analysis would be problematic as historical relationships may change over time and, additionally, would require individualized determinations. In light of these circumstances, the Commission determined that it was not necessary to expand the scope of position limits beyond what was adopted. The Commission also noted that the commenters did not provide specific criteria or thresholds for making determinations as to which price-correlated commodity contracts should be subject to limits, further noting that it would consider amending the scope of economically equivalent contracts (and the relevant identifying criteria) as it gained experience in this area.[193]

The definition for "referenced contract" proposed in §150.1 mirrors the definition proposed in §151.1, with the delineation of several related terms incorporated into the definition.[194] The beginning of the current definition parallels the definition in vacated §151.1, differing only with the addition of a clarification that the definition of "referenced contract" does not include guarantees of a swap. This clarification is added

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[193] Id.

[194] In the current rulemaking, the term "referenced contract" is defined in § 150.1 to mean, on a futures-equivalent basis with respect to a particular core referenced futures contract, "a core referenced futures contract listed in § 151.2(d) of this part, or a futures contract, options contract, or swap, other than a 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; or (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; and (2) Where: (a) Calendar spread contract means a cash-settled agreement, contract, or transaction that represents the difference between the settlement price in one or a series of contract months of an agreement, contract or transaction and the settlement price of another contract month or another series of contract months' settlement prices for the same agreement, contract or transaction; (b) 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; (c) Spread contract means either a calendar spread contract or an intercommodity spread contract; and (d) Intercommodity spread contract means a cash-settled agreement, contract or transaction that represents the difference between the settlement price of a referenced contract and the settlement price of another contract, agreement, or transaction that is based on a different commodity."

into the list of products that are not included in the definition.[195] In the proposed definition, "referenced contract" would not include "a guarantee of a swap, a basis contract, or a commodity index contract."[196] In addition, for the sake of clarify, the proposal incorporates into the definition of "referenced contract" several related terms. Consequently, the definition for "referenced contract" delineates the meaning of "calendar spread contract," "commodity index contract," "spread contract," and "intercommodity spread contract."[197] The incorporation of these terms into the definition of "referenced contract" is intended to retain in one place the various parts and meanings of the definition, thereby facilitating comprehension of the definition.

p. Short position

The term "short position" is currently defined in § 150.1(c) to mean "a short call option, a long put option, or a short underlying futures contract." Vacated part 151 did not retain this definition. The current proposal would amend the definition to state that a short position means "a short call option, a long put option or a short underlying futures contract, or a short futures-equivalent swap." This revised definition reflects the fact that

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[195] As defined in vacated § 151.1, "Referenced Contract" excludes "a basis contract or contract on a commodity index." See vacated § 151.1.

[196] The Commission proposes to exclude a guarantee of a swap from the definition of a referenced contract due to regulatory developments that occurred after the vacated part 151 Rulemaking. In connection with further defining the term "swap" jointly with the Securities and Exchange Commission, (see generally Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 FR 48208, Aug. 13, 2012 ("Product Definitions Adopting Release")), the Commission interpreted the term "swap" (that is not a "security-based swap" or "mixed swap") to include a guarantee of such swap, to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the position. See id. at 48226. Excluding guarantees of swaps from the definition of referenced contract should help avoid any potential confusion regarding the application of position limits to guarantees of swaps, which could impede the Commission's efforts to monitor compliance with the requirements of the CEA. In addition, if the rules proposed in the Aggregation NPRM are adopted, it would obviate the need to include guarantees of swaps in the definition of referenced contracts.

[197] Compare vacated § 151.1 with proposed § 150.1.

under the Dodd-Frank Act, the Commission is charged with applying the position limits regime to swaps.

q. <u>Speculative Position Limit</u>

The term "speculative position limit" is currently not defined in § 150.1 and was not defined in vacated part 151. The Commission now proposes to define the term "speculative position limit" to mean "the maximum position, either net long or net 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, or a person's position in the spot month of commodity derivative contacts in a particular commodity. Such a limit may be established under federal regulations or rules of a designated contract market or swap execution facility. An exchange may also apply other limits, such as a limit on gross long or gross short positions, or a limit on holding or controlling delivery instruments."

This proposed definition is similar to definitions for position limits used by the Commission for many years; the various regulations and defined terms included use of maximum amounts "net long or net short," which limited what any one person could "hold or control," "one grain on any one contract market" (or in "in one commodity" or "a particular commodity"), and "in any one future or in all futures combined." For example, in 1936, Congress enacted the CEA, which authorized the CFTC's predecessor, the CEC, to establish limits on speculative trading. Congress empowered the CEC to "fix

such limits on the amount of trading ... as the [CEC] finds is necessary to diminish, eliminate, or prevent such burden."[198] The first speculative position limits were issued by the CEC in December 1938.[199] Those first speculative position limits rules provided in § 150.1 for limits on position and daily trading in grain for future delivery, adopting a maximum amount "net long or net short position which any one person may hold or control in any one grain on any one contract market" as 2,000,000 bushels "in any one future or in all futures combined."[200]

Another example is found in the glossaries published by the Commission for many years. Various Commission documents over the years have included a glossary. For example, the Commission's annual report for 1983 includes in its glossary "Position Limit The maximum position, either net long or net short, in one commodity future combined which may be held or controlled by one person as prescribed by any exchange or by the CFTC." The version of the staff glossary currently posted on the CFTC website defines speculative position limit as "[t]he maximum position, either net long or net short, in one commodity future (or option) or in all futures (or options) of one commodity combined that may be held or controlled by one person (other than a person eligible for a hedge exemption) as prescribed by an exchange and/or by the CFTC."

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[198] CEA section 6a(1) (Supp. II 1936).

[199] 3 FR 3145, Dec. 24, 1938.

[200] 17 CFR 150.1 (1938) (Part 150 - Orders of The Commodity Exchange Commission)("Limits on position and daily trading in grain for future delivery. The following limits on the amount of trading under contracts of sale of grain for future delivery on or subject to the rules of contract markets which may be done by any person are hereby proclaimed and fixed, to be in full force and effect on and after December 31, 1938: (a) Position limits. (1) The limit on the maximum net long or net short position which any one person may hold or control in any one grain on any one contract market, except as specifically authorized by paragraph (a) (2), is: 2,000,000 bushels in any one future or in all futures combined. (2) To the extent that the net position held or controlled by any one person in all futures combined in any one grain on 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 (a)(1) 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.").

r. <u>Spot month</u>

Vacated part 151 adopted an amended definition for "spot month" that replaced the definition for spot month currently found in § 150.1 by citing to the definition provided in § 151.3. Vacated § 151.3 provided detailed lists of spot months separately for agricultural, metals and energy commodities.

The Commission proposes to adopt a simplified update to the definition of "spot month" by expanding upon the current § 150.1 definition. The definition, as expanded, would specifically address both physical-delivery contracts and cash-settled contracts, and clarify the duration of "spot month." Under the proposed changes, the term "spot month" does not refer to a month of time. Rather, the definition clarifies that the "spot month" is 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. The definition continues to define the spot month as the period of time beginning at of the close of trading on the trading day preceding the first day on which delivery notices can be issued to the clearing organization of a contract market, while adding in a clarification that this definition applies only to physical-delivery commodity derivatives contracts. For physical-delivery contracts with delivery beginning after the last trading day, the proposal defines the spot month as the close of trading on the trading day preceding the third-to-last trading day, until the contract is no longer listed for trading (or available for transfer, such as through exchange for physical transactions). This definition is consistent with the current spot month for each of the 28 core referenced futures contracts. The definition proposes similar, but slightly different language for cash-settled contracts, providing that the spot

month begins at the earlier of the start of the period in which the underlying cash-settlement price is calculated or the close of trading on the trading day preceding the third-to-last trading day and continues until the contract cash-settlement price is determined.[201] In addition, the definition includes a proviso that, if the cash-settlement 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 that core referenced futures contract.[202]

s. Spot-month, single-month, and all-months-combined position limits

In addition to a definition for "spot month," current part 150 includes definitions for "single month," and for "all-months" where "single month" is defined as "each separate futures trading month, other than the spot month future," and "all-months" is defined as "the sum of all futures trading months including the spot month future."

Vacated part 151 retained only the definition for spot month, and, instead, adopted a definition for "spot-month, single-month, and all-months-combined position limits." The definition provided that, for Referenced Contracts based on a commodity identified in § 151.2, the maximum number of contracts a trader may hold was as provided in § 151.4.

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[201] For example, a "look-alike" contract that references a calendar-month average of settlement prices would have the same spot-month limit as the core referenced futures contract (CRFC) but the limit would be in effect beginning with the first calendar day of the cash-settlement period; a "look-alike" contract that references a single day's settlement price in the spot-month of the CRFC would have a spot-month limit at the same level as the CRFC but the limit would be in effect only during the spot month of the CRFC.

[202] For example, the physical-delivery NYMEX Henry Hub Natural Gas futures contract would have, as is currently the case for the exchange spot month limit, a spot period beginning on close of trading three business days prior to the last trading day of that core referenced futures contract. The NYMEX Henry Hub Natural Gas Penultimate Financial futures contract (which is cash-settled based on the NYMEX Henry Hub Natural Gas Futures contract settlement price on the business day preceding the last trading day for that physical-delivery contract, and is currently subject to position accountability effective on the last three trading days of the futures contract), would have a spot month period that is the same as that of the physical-delivery NYMEX Henry Hub Natural Gas futures contract.

In the current rulemaking proposal, as noted above, the Commission proposes to amend § 150.1 by deleting the definitions for "single month," and for "all-months." Unlike the vacated part 151 Rulemaking, the current proposal does not include a definition for "spot-month, single-month, and all-months-combined position limits." Instead, the current rulemaking proposes to adopt a definition for "speculative position limits" that should obviate the need for these definitions.[203]

t. Spread contract

Spread contract was defined in vacated part 151 as "either a calendar spread contract or an intercommodity spread contract."[204] The Commission proposes to add the same definition into § 150.1 in conjunction with the proposal to define "referenced contract."[205]

The Commission also notes that while the proposed definition of "referenced contract" specifically excludes guarantees of a swap, basis contracts and commodity index contracts, spread contracts are not excluded from the proposed definition of "referenced contract."[206]

u. Swap

The definitions of several terms adopted in vacated part 151 relied on the statutory definition in some cases in conjunction with a further definition adopted by the

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[203] See supra discussion of the proposed definition of "speculative position limit."

[204] Vacated § 151.1.

[205] See supra discussion of proposed §150.1 "referenced contract" definition.

[206] The Commission notes that this is consistent with vacated part 151. See, e.g., the final part 151 Rulemaking, which noted that commodity index contracts, which by the definition in vacated § 151.1 were expressly excluded from the definition of ''Referenced Contract,'' were not spread contracts. 76 FR at 71656. See also, the definition of "commodity index contract," which is defined as "a contract, agreement, or transaction ''that is not a basis or any type of spread contract, [and] based on an index comprised of prices of commodities that are not the same nor substantially the same.'' Vacated § 151.1.

Commission in other rulemakings.[207] Other defined terms that rely on the statutory definition in included: "entity," "excluded commodity," and "swap dealer." Since the adoption of part 151, the Commission, in a joint rulemaking with the Securities and Exchange Commission, adopted a further definition for "swap" in § 1.3(xxx).[208] Consequently, the definition of "swap" proposed in the current rulemaking, while paralleling that of the definition included in vacated § 151.1, and while substantially the same, additionally cites to the definition of "swap" found in § 1.3(xxx).

v. <u>Swap dealer</u>

The term "swap dealer" is not currently defined in § 150.1, but was defined in vacated 151.1 to mean "'swap dealer' as that term is defined in section 1a of the Act and as further defined by the Commission."[209] Similar to the definition of "swap," the Commission adopted a definition for "swap dealer" since part 151 was finalized.[210] Under the current proposal, § 150.1 would be amend to define "swap dealer" to mean "'swap dealer' as that term is defined in section 1a of the Act and as further defined in section 1.3 of this chapter.'' This revised definition reflects the fact that the definition of "swap dealer," while paralleling that of the definition included in § 151.1, and while substantially the same, additionally cites to the definition of "swap dealer" found in § 1.3(ggg).

ii. <u>Bona fide hedging definition</u>

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[207] Under vacated § 151.1, the term "[s]wap means 'swap' as defined in section 1a of the Act and as further defined by the Commission."

[208] <u>See</u> 77 FR 48208, 48349, Aug. 13, 2012.

[209] <u>See</u> vacated § 151.1.

[210] 77 FR 30596, May 23, 2012.

The core of the Commission's approach to defining bona fide hedging over the years has focused on transactions that offset a recognized physical price risk.[211] Once a bona fide hedge is implemented, the hedged entity should be price insensitive because any change in the value of the underlying physical commodity is offset by the change in value of the entity's physical commodity derivative position.

Because a firm that has hedged its price exposure is price neutral in its overall physical commodity position, the hedged entity should have little incentive to manipulate or engage in other abusive market practices to affect prices. By contrast, a party that maintains a derivative position that leaves them with exposure to price changes is not neutral as to price and, therefore, may have an incentive to affect prices. Further, the intention of a hedge exemption is to enable a commercial entity to offset its price risk; it was never intended to facilitate taking on additional price risk.

The Commission recognizes there are complexities to analyzing the various commercial price risks applicable to particular commercial circumstances in order to determine whether a hedge exemption is warranted. These complexities have led the Commission, from time to time, to issue rule changes, interpretations, and exemptions. Congress, too, has periodically revised the Federal statutes applicable to bona fide hedging, most recently in the Dodd-Frank Act. These complexities will be further explored below.

a. <u>Bona fide hedging history</u>

[211] For an historical perspective on the bona fide hedging provision prior to the Dodd-Frank amendments, see Testimony of General Counsel Dan M. Berkovitz, Commodity Futures Trading Commission, "Position Limits and the Hedge Exemption, Brief Legislative History," July 28, 2009, available at http://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement072809.

Prior to 1974, the term bona fide hedging transactions or positions was defined in section 4a(3) of the Act. That definition only applied to agricultural commodities. When the Commission was created in 1974, the Act's definition of commodity was expanded. At that time, Congress was concerned that the limited hedging definition, even if applied to newly regulated commodity futures, would fail to accommodate the commercial risk management needs of market participants that could emerge over time. Accordingly, Congress, in section 404 of the Commodity Futures Trading Commission Act of 1974, repealed the statutory definition and gave the Commission the authority to define bona fide hedging.[212] In response to the 1974 legislation, the Commission's predecessor adopted in 1975 a bona fide hedging definition in § 1.3(z) of its regulations stating, among other requirements, that transactions or positions would not be classified as hedging unless their bona fide purpose was to offset price risks incidental to commercial cash or spot operations, and such positions were established and liquidated in an orderly manner and in accordance with sound commercial practices.[213] Shortly thereafter, the newly formed Commission sought comment on amending that definition.[214] Given the large number of issues raised in comment letters, the Commission adopted the

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[212] Section 404 of Pub. L. 93-463, October 23, 1974, (CFTC Act), amended section 4a(3) of the Act, deleting the statutory definition of bona fide hedging position or transaction and directing the newly-established Commission to issue a rule defining that term.

[213] Pending promulgation of a definition by the Commission, the Secretary of Agriculture promulgated § 1.3(z) pursuant to section 404 of the CFTC Act. 40 FR 11560, Mar. 12, 1975. This definition of bona fide hedging in new § 1.3(z) deviated in only minor ways from the hedging definition contained in section 4a(3) of the Act. The Commodity Exchange Commission subsequently issued conforming amendments to various rules. 40 FR 15086, Apr. 4, 1975.

[214] 40 FR 34627, Aug. 18, 1975. The Commission sought comment on many issues, including whether to include in the definition of bona fide hedging transactions and positions "the practice of many traders which results in hedging of gross cash positions rather than a net cash position — so-called 'double hedging.'" Id. at 34628. The Commission later noted "that net cash positions do not necessarily measure total risk exposure and in such cases the hedging of gross cash positions does not constitute 'double hedging.'" 42 FR 42748, 42750, Aug. 24, 1977.

predecessor's definition with minor changes as an interim definition of bona fide hedging transactions or positions, effective October 18, 1975.[215]

In 1977, the Commission proposed a revised definition of bona fide hedging that largely forms the basis of the current definition of bona fide hedging.[216] The 1977 proposed definition set forth: (i) a general definition of bona fide hedging positions under economically appropriate circumstances and subject to other conditions (noted below); (ii) an enumerated list of specific positions that conform to the general definition; and (iii) a procedure to consider non-enumerated cases.[217] The 1977 proposal, as adopted, established the concept of portfolio hedging and recognized cross-commodity hedges and hedges of anticipated production or unfilled anticipated requirements, provided such hedges were not recognized in the five last days of trading in any particular futures contract (the "five-day rule" in current § 1.3(z)(2)).[218]

The general definition of bona fide hedging in current § 1.3(z), as was the case when adopted in 1977, advises that a position should "normally represent a substitute for … positions to be taken at a later time in a physical marketing channel," and requires such position to be "economically appropriate to the reduction of risks in the conduct of a commercial enterprise," and where the risks arise from the potential change in value of assets, liabilities or services.[219] Such bona fide hedges also must have a purpose "to offset price risks incidental to commercial cash or spot operations" and must be

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[215] 40 FR 48688, Oct. 17, 1975. The Commission re-issued all regulations, with rule 1.3(z) essentially unchanged, in 1976. 41 FR 3192, 3195, Jan. 21, 1976.

[216].42 FR 14832, Mar.16, 1977

[217] Id.

[218] 42 FR 42748, Aug. 24, 1977.

[219] 17 CFR 1.3(z)(1) (2010). The Commission cautions that the e-CFR version of § 1.3(z) reflects changes made by the vacated 2011 final rule.

"established and liquidated in an orderly manner in accordance with sound commercial practices." Thus a bona fide hedge exemption was appropriate where there was a demonstrated physical price risk that had been recognized. This also applies, for example, to bona fide hedge exemptions for unfilled anticipated requirements, where processors or manufacturers are exposed to price risk on such unfilled anticipated requirements necessary for their manufacturing or processing.[220]

The 1977 proposed definition did not include the modifying adverb "normally" to the verb "represent."[221] The Commission explained in the 1977 preamble it intended to recognize bona fide hedging positions "on the basis of net risk related to changes in the values reflected on balance sheets."[222] The Commission introduced the adverb normally in the 1977 final rulemaking in order to make clear it would recognize as bona fide such balance sheet hedging and "other [at the time] relatively infrequent but potentially important examples of risk reducing futures transactions" that would otherwise not have met the general definition of bona fide hedging.[223] The Commission noted: "One form of balance sheet hedging would involve offsetting net exposure to changes in currency exchange rates for the purpose of stabilizing the domestic dollar accounting value of assets which are held abroad. In the case of depreciable capital assets, such hedging

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[220] The Commission notes that the definition of bona fide hedging transactions or positions historically included an exemption for unfilled anticipated requirements. As the Commission stated in 1974, in its proposal to adopt § 1.3(z), the regulation on the hedging definition proposed by the Secretary of Agriculture was intended to comply with the intent of section 404 of Pub. L. 93-463, enacted October 23, 1974, as stated in the Conference Report accompanying HR. 13113, pp. 40-1. The Commission noted in its proposal that the new statutory language was intended to allow processors and manufacturers to hedge unfilled annual requirements. 39 FR 39731, Nov. 11, 1974.

[221] See 42 FR 42748, Aug. 24, 1977.

[222] Id.

[223] 42 FR at 42749.

transactions might not represent a substitute for subsequent transactions in a physical marketing channel."[224]

With respect to the five-day rule in current § 1.3(z)(2) for anticipatory hedges of unfilled anticipated requirements, the Commission observed that historically there was a low utilization of this provision in terms of actual positions acquired in the futures market.[225] For cross commodity and short anticipatory hedge positions, the Commission did "not believe that persons who do not possess or do not have a commercial need for the commodity for future delivery will normally wish to participate in the delivery process."[226]

In 1979, the Commission eliminated daily speculative trading volume limits and concluded such daily trading limits were "not necessary to diminish, eliminate or prevent excessive speculation."[227] The Commission noted eliminating daily trading limits had no effect on the limits on the size of speculative positions which any one person may hold or control on a single contract market. The Commission also noted the speculative position limits apply to positions throughout the day as well as to positions at the close of the trading session.[228] The Commission continues to apply position limits throughout the day and will continue under this proposal.

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[224] Id. at 42749 (n. 1).

[225] Id. at 42749. The five-day rule in current § 1.3(z)(2) for anticipatory hedges permits an exception for a person with a long anticipatory hedging need, for up to two months unfilled anticipated requirements.

[226] Id.

[227] 44 FR 7124, Feb. 6, 1979.

[228] Id. at 7125.

In the aftermath of the silver futures market crisis during late 1979 to early 1980,[229] in 1981 the Commission adopted § 1.61, subsequently incorporated into § 150.5, requiring DCMs to adopt speculative position limits and providing an exemption for "bona fide hedging positions as defined by a contract market in accordance with § 1.3(z)(1) of the Commission's regulations."[230] That rule permits DCMs to limit bona fide hedging positions which it determines are not in accord with sound commercial practices or exceed an amount which the exchange determines may be established or liquidated in an orderly fashion.

In 1986, in response to concerns raised in testimony regarding the constraints on investment decisions imposed by position limits, the House Committee on Agriculture, in its report accompanying the Commission's 1986 reauthorization legislation, instructed the Commission to reexamine its approach to speculative position limits and its definition of hedging.[231] Specifically, the Committee Report "strongly urge[d] the Commission to undertake a review of its hedging definition . . . and to consider giving certain concepts, uses, and strategies 'non-speculative' treatment . . . whether under the hedging definition or, if appropriate, as a separate category similar to the treatment given certain spread, straddle or arbitrage positions . . ."[232] The Committee Report singled out four categories of trading and positions that the Commission should consider recognizing as non-

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[229] See, In re Nelson Bunker Hunt et al., CFTC Docket No. 85-12.

[230] 46 FR 50938, 50945, Oct. 16, 1981. With the passage of the Commodity Futures Modernization Act in 2000 and the Commission's subsequent adoption of the part 38 regulations covering DCMs in 2001 (66 FR 42256, Aug. 10, 2001), part 150's approach to exchange-set speculative position limits was incorporated as an acceptable practice under DCM Core Principle 5 — Position Limitations and Accountability. 72 FR 66097, 66098 n.1, Nov. 27, 2007.

[231] House Committee on Agriculture, Futures Trading Act of 1986, H.R. Rep. No. 624, 99th Cong., 2d Sess. 44-46 (1986).

[232] Id. at 46.

speculative: (i) ''risk management'' trading by portfolio managers as an alternative to the concept of ''risk reduction;'' (ii) futures positions taken as alternatives to, rather than as temporary substitutes for, cash market positions; (iii) other positions acquired to implement strategies involving the use of financial futures including, but not limited to, asset allocation (altering portfolio exposure in certain areas such as equity and debt), portfolio immunization (curing mismatches between the duration and sensitivity of assets and liabilities to ensure that portfolio assets will be sufficient to fund the payment of liabilities), and portfolio duration (altering the average maturity of a portfolio's assets); and (iv) certain options trading, in particular the writing of covered puts and calls.[233]

The Senate Committee on Agriculture, Nutrition and Forestry, in its report on the 1986 CFTC reauthorization legislation, also directed the Commission to reassess its interpretation of bona fide hedging.[234] Specifically, the Senate Committee directed the Commission to consider ''whether the concept of prudent risk management [should] be incorporated in the general definition of hedging as an alternative to this risk reduction standard.''[235]

The Commission heeded Congress's recommendation, and the Commission issued two 1987 interpretive statements regarding the definition of bona fide hedging. The first 1987 interpretative statement clarified the meaning of current § 1.3(z)(1).[236]

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[233] Id.

[234] Senate Committee on Agriculture, Nutrition and Forestry, Futures Trading Act of 1986, S. Rep. No. 291, 99th Cong., 2d Sess. at 21–22 (1986).

[235] Id. at 22.

[236] See, Clarification of Certain Aspect of the Hedging Definition, 52 FR 27195, Jul. 20, 1987 (July 1987 Interpretative Statement).

The Commission interpreted the regulatory "temporary substitute" criterion[237] not to be a necessary condition for classification of positions as hedging. The Commission interpreted the "incidental test"[238] to be a "requirement that the risks that are offset by a futures or option hedge must arise from commercial cash market activities." The Commission also noted bona fide hedges could include balance sheet and other trading strategies that are risk reducing, such as "strategies that provide protection equivalent to a put option for an existing portfolio of securities."[239]

The second 1987 interpretative statement provides assistance to an exchange who may wish to recognize risk management exemptions from exchange speculative position limit rules.[240] "The Commission note[d] that providing risk management exemptions to commercial entities who are typically engaged in buying, selling or holding cash market instruments is similar to a provision in the Commission's hedging definition, [namely], the risks to be hedged arise in the management and conduct of a commercial enterprise."[241] The Commission believed that it would be consistent with the objectives of section 4a of the Act and § 1.61 [now incorporated as § 150.5] for exchange rules to exempt from speculative limits a number of risk management positions in debt-based, equity-based and foreign currency futures and options.[242] Those positions included: unleveraged long positions (covered by cash set aside); short calls on securities or

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[237] In current § 1.3(z)(1), the phrase "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" has been termed the "temporary substitute criterion." (Emphasis added.)

[238] In current § 1.3(z)(1), the phrase "price risks incidental to commercial cash or spot operations" has been termed the "incidental test."

[239] 52 FR at 27197.

[240] See, Risk Management Exemptions from Speculative Position Limits Approved under Commission Regulation 1.61, 52 FR 34633, Sep. 14, 1987.

[241] Id. at 34637.

[242] Id. at 34636.

currencies owned (i.e., covered calls); and long positions in asset allocation strategies covered by hedged debt securities or currencies owned.[243]

In 1987, the Commission also added an enumerated hedging position for spread positions which offset unfixed-price cash sales and unfixed-price cash purchases that are priced basis different delivery months in a futures contract (that is, floating-price cash purchases coupled with floating-price cash sales).[244] In this regard, the Commission extended the cross-commodity hedging provisions to offsets of such coupled floating-price cash contracts that were not cash market transactions in the same commodity underlying the futures contract.[245]

The Commission adopted federal limits on soybean meal and soybean oil futures contracts in 1987, in response to a petition by the Chicago Board of Trade.[246] In the final rule, the Commission noted: "Crush positions allow the processor to determine or fix his processing margin in advance and are included within the exemptions permitted for anticipatory hedging under Commission Rule 1.3(z)(2)."[247] Specifically, the Commission noted for a crush position established by a soybean processor, the short positions in soybean oil and soybean meal futures would be permitted to the extent of twelve months unsold anticipated production; and the long positions in soybean futures would be permitted to the extent of twelve months unfilled anticipated requirements. The Commission declined to adopt an exemption for a reverse crush position. The Commission stated its belief, based upon comments received and its own analysis, "that

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[243] Id.

[244] 52 FR 38914, 38919, Oct. 20, 1987.

[245] Id. at 38922.

[246] Petition for rulemaking of the CBOT, dated July 24, 1986, cited in 52 FR 6814, Mar. 5, 1987.

[247] 52 FR 38914, 38920, Oct. 20, 1987.

there are important differences between the crush and reverse crush positions from the standpoint of bona fide hedging by soybean processors." The results of a crush position, plus or minus basis variation, are known once the position is established. In contrast, the Commission noted with a reverse crush spread position, "the intended results transpire only if, and when, the futures markets reflect the expected or anticipated more favorable crushing margin and the position can be lifted." Accordingly, the Commission noted it did not appear appropriate to recognize the reverse crush spread position as an enumerated category of bona fide hedging.[248]

In 2007, the Commission proposed a risk management exemption to federal position limits, in addition to the bona fide hedging exemption.[249] A risk management position would have been defined as a futures or futures equivalent position held as part of a broadly diversified portfolio of long-only or short-only futures or futures equivalent positions, that is based on either tracking a broadly diversified index for clients or a portfolio diversification plan that included an exposure to a broadly diversified index. In either case, the exemption would have been conditioned on the futures positions being passively managed, unleveraged, and outside of the spot month. The Commission withdrew that proposal in 2008, citing a lack of consensus.[250]

In March of 2009, the Commission issued a concept release on whether to eliminate the bona fide hedge exemption for certain swap dealers and create a new limited risk management exemption from speculative position limits.[251] The Commission

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[248] Id. The Commission noted at that time that the determination of whether a reverse crush position is bona fide hedging should be made on a case-by-case basis under § 1.47.

[249] 72 FR 66097, Nov. 27, 2007.

[250] 73 FR 32261, Jun. 6, 2008.

[251] 74 FR 12282, Mar. 24, 2009.

explained that, beginning in 1991, the Commission had granted bona fide hedge exemptions under § 1.47 to a number of swap intermediaries who were seeking to manage price risk on their books as a result of their serving as counterparties to their swap clients in commodity index swap contracts or commodity swap contracts.[252] The swap clients included pension funds and other passive investors who were not using swaps to offset risks in the physical marketing channel. In order to protect itself from the risks of such swaps, the swap intermediary would establish a portfolio of long futures positions in the commodities making up the index or the commodity underlying the swap, in such amounts as would offset its exposure under the swap transaction. By design, the commodity index did not include contract months in the spot month. The exemptions did not cover positions carried into the spot month. The comments on the March 2009 concept release were about equally divided between those who favored eliminating the bona fide hedge exemption for swap dealers (or restricting the exemption to positions offsetting swap dealers' exposure to traditional commercial market users) and those who favored retaining the swap dealer hedge exemption in its current form, or some variation thereof.[253]

In January of 2010, the Commission proposed an integrated speculative position framework for the major energy contracts listed on DCMs.[254] The proposed rules would not have recognized futures and option transactions offsetting exposure acquired pursuant to swap dealing activity as bona fide hedges. Instead, upon compliance with several conditions including reporting and disclosure obligations, the proposed regulations would

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[252] Id. at 12284.

[253] The comments are available for review on the Commission's Web site at http://www.cftc.gov/LawRegulation/PublicComments/09-004.

[254] 75 FR 4144, Jan. 26, 2010 (withdrawn 75 FR 50950, Aug. 18, 2010).

have allowed swap dealers to seek a limited exemption from the proposed speculative position limits for the major energy contracts.[255] The proposed framework was withdrawn after enactment of the Dodd-Frank Act, which the Commission interprets as expanding the range of derivative contracts, beyond contracts listed on DCMs, on which the Commission must impose position limits.

Since 1974, the Commission has had authority under the Act to define the term bona fide hedging position. With the enactment on July 21, 2010 of the Dodd-Frank Act, section 4a(c)(1) of the Act,[256] continues to provide that position limits do not apply to positions shown to be bona fide hedging positions as defined by the Commission.[257] However, Dodd-Frank added section 4a(c)(2) of the Act, which the Commission interprets as directing the Commission to narrow the bona fide hedging position definition for physical commodities from the definition found in current § 1.3(z)(1), as discussed further below.[258] Separately, Dodd-Frank added section 4a(a)(7) of the Act to give the Commission plenary authority to grant general exemptive relief from the position limit rules.[259]

On November 18, 2011, the Commission adopted part 151 to establish a position limits regime for twenty-eight exempt and agricultural commodity futures and options contracts and the physical commodity swaps that are

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[255] 75 FR at 4152.

[256] 7 U.S.C. 6a(c)(1).

[257] Id. The Dodd-Frank Act did not change the language found in prior 7 U.S.C. 6a(c) (2010).

[258] See infra discussion of "temporary substitute test."

[259] Section 4a(a)(7) of the Act provides: "The Commission, by rule, regulation, or order, may exempt, conditionally or unconditionally, any person or class of persons, any swap or class of swaps, any contract of sale of a commodity for future delivery or class of such contracts, any option or class of options, or any transaction or class of transactions from any requirement it may establish under this section with respect to position limits." 7 U.S.C. 6a(a)(7).

economically equivalent to such contracts.[260] In connection with issuing the part 151 limits, the Commission defined bona fide hedging transactions or positions in § 151.5(a) and enumerated eight transactions or positions that would constitute bona fide hedging transactions or positions and, thus, would be exempt from the part 151 limits.[261]

In addition to the exemptions enumerated in § 151.5(a)(2) and (5) provided that, "Any person engaging in other risk reducing practices commonly used in the market which they believe may not be specifically enumerated in § 151.5(a)(2) may request relief from Commission staff under § 140.99 of this chapter[262] or the Commission under section 4a(a)(7) of the Act concerning the applicability of the bona fide hedging transaction exemption."[263]

On January 20, 2012, the Working Group of Commercial Energy Firms (the "Working Group") filed a petition pursuant to both section 4a(a)(7) of the Act and § 151.5(a)(5) (the "Working Group Petition")[264] requesting that the Commission "grant exemptive relief for [ten] classes of risk-reducing transactions described [in the petition] to the extent that such transactions are not covered by [§§]

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[260] See generally 76 FR 71626, Nov. 18, 2011.

[261] See 17 CFR 151.5(a)(2)(i)-(viii). The Commission also recognized pass-through swaps and pass-through swap offsets as bona fide hedging transactions. 17 CFR 151.5(a)(3)-(4).

[262] Section 140.99 sets out general procedures and requirements for requests to Commission staff for exemptive, no-action and interpretative letters.

[263] 17 CFR § 151.5(a)(5).

[264] The Working Group Petition is available at http://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/wgbfhpetition012012.pdf. The Working Group supplemented the petition in a letter dated April 17, 2012, available at http://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/workinggroupltr041712.pdf. As noted in their submission, the Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to, among others, industrial, commercial and residential consumers. Members of the Working Group and their affiliates actively trade futures and swaps and they assert that they would be materially impacted by position limit rules under part 151.

151.5(a)(1) or (2) of the Position Limit Rules or, in the alternative, clarify that such classes of transactions qualify as 'bona fide hedging transactions or positions' within the meaning of [§§] 151.5(a)(1) and (2); [("Requests One – Ten")] and provide exemptive relief regarding the definition of (a) 'spot month" set forth in [§] 151.3(c) of the Position Limit Rules, and (b) "swaption' set forth in [§] 151.1 of the Position Limit Rules [('Other Requests)]."[265] In connection with any relief ultimately granted as a result of the Petition, the Working Group also requested that the Commission "confirm that any relief granted is generally applicable to the entire market."[266]

In addition to the Working Group Petition, on March 13, 2012, the American Petroleum Institute ("API") also filed a petition pursuant to both section 4a(a)(7) of the Act and § 151.5(a)(5) (the "API Petition").[267] The API Petition generally endorsed the Working Group petition and requested that the Commission recognize as bona fide hedging transactions certain routine energy market transactions that are priced at monthly average index prices.[268] The request in the API Petition is essentially a restatement of Requests One through

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[265] See Working Group Petition at 1.

[266] See Working Group Petition at 3. In letters dated March 1,2012, and March 26, 2012, respectively, a group of three energy trade associations (Edison Electric Institute, American Gas Association, and Electric Power Supply Association), and the Futures Industry Association submitted comments in support of the Working Group Petition, available at http://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/eei-aga-epsa_comments.pdf and http://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/fialtr032612.pdf.

[267] The API Petition is available at http://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/apiltr031312.pdf. As noted in their submission, API is a national trade association representing more than 450 oil and natural gas companies. Its members transact in physical and financial, exchange-traded, and over-the-counter markets primarily to hedge or mitigate commercial risks associated with their core business of delivering energy to wholesale and retail customers.

[268] See API Petition at 1.

Three of the Working Group Petition. The API Petition also requested relief for pass-through swaps.

Further, the CME Group, on April 26, 2012, filed a petition pursuant to section 4a(a)(7) of the Act and § 151.5(a)(5) (the "CME Petition").[269] The CME Petition generally requested that the Commission recognize as bona fide hedging transactions certain purchases by persons engaged in processing, manufacturing or feeding that were permitted under § 1.3(z)(2)(ii)(C) during the last five trading days in physical-delivery contracts, not to exceed anticipated requirements for that month and the next succeeding month. The request in the CME Petition is substantively similar to Request Eight of the Working Group Petition.

With the court's September 28, 2012, order vacating part 151, the Commission now re-proposes a definition of bona fide hedging position.

b. Proposed definition of bona fide hedging position

The Commission proposes to delete § 1.3(z), the current definition of "bona fide hedging transactions or positions," and replace it with a new definition of "bona fide hedging position" in § 150.1.[270] Section 4a(c)(1) of the Act, as added by the Dodd-Frank Act, authorizes the Commission to define bona fide hedging positions "consistent with the purposes of this Act."[271] The proposed definition of bona fide hedging position builds on the Commission's history, both in administering a regulatory exemption to federal limits and in providing guidance to exchanges in establishing exchange limits,

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[269] The CME Petition is available at http://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/cmeltr042612.pdf.

[270] The proposed definition does not reference "transactions" because the Commission has not had trading volume limits on transactions since 1979. See generally Elimination of Daily Speculative trading Limits, 44 FR 7124, Feb. 6, 1979.

[271] 7 U.S.C. 6a(c)(1).

and is grounded for physical commodities on the new requirements in section 4a(c)(2) of the Act, as amended by section 737 of the Dodd-Frank Act in July 2010.[272]

Organization. The proposed definition of bona fide hedging position is organized into six sections: an opening paragraph with two general requirements for all hedges; and five numbered paragraphs (paragraphs (1)-(5)). Paragraph (1) of the proposed definition sets forth requirements for hedges of an excluded commodity, and incorporates guidance on risk management exemptions that may be adopted by an exchange.[273] Paragraph (2) lists requirements for hedges of a physical commodity. Paragraphs (3) and (4) list enumerated exemptions. Paragraph (5) specifies the requirements for cross-commodity hedges.

c. General requirements for all bona fide hedges — opening paragraph

The opening paragraph of the proposed definition sets forth two general requirements for any legitimate hedging position: (i) the purpose of the position must be to offset price risks incidental to commercial cash operations (the "incidental test"); and (ii) the position must be established and liquidated in an orderly manner in accordance with sound commercial practices (the "orderly trading requirement"). These general requirements are found in current § 1.3(z)(1).[274]

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[272] 7 U.S.C. 6a(c)(2).

[273] Regarding the definition of bona fide hedging positions in excluded commodities, the Commission notes this proposed definition also would provide flexibility to exchanges adopting exemptions for securities futures contracts consistent with § 41.25(a)(3)(iii).

[274] In relevant part, current § 1.3(z)(1) provides: "Notwithstanding the foregoing, no transaction or position shall be classified as bona fide hedging for purposes of section 4a of the Act unless their purpose is to offset price risks incidental to commercial cash or spot operations and such position are established and liquidated in an orderly manner in accordance with sound commercial practices and [unless other] provisions [of this definition] have been satisfied." 17 CFR 1.3(z)(1). The second characteristic was contained in vacated § 151.5(a)(1)(v).

Incidental test. Consistent with its prior interpretation of the incidental test under § 1.3(z)(1), discussed above, the Commission intends the proposed incidental test to be a requirement that the risks offset by a commodity derivative contract hedging position must arise from commercial cash market activities.[275] The Commission believes this requirement is consistent with the statutory guidance to define bona fide hedging positions to permit hedging "legitimate anticipated business needs."[276] In the absence of a requirement for a legitimate business need, the Commission believes it would be difficult to distinguish between hedging and speculative activities. The Commission believes the concept of commercial cash market activities is also embodied in the economically appropriate test for physical commodities in section 4a(c)(2) of the Act, discussed below. The proposed incidental test amends the incidental test in current § 1.3(z)(1) by clarifying that forward commercial operations may also serve as the basis for a bona fide hedging position.[277] This is consistent with the Commission's long-standing recognition of fixed-price purchase and fixed-price sales contracts (which may specify forward delivery dates) as the basis of certain enumerated hedges in current § 1.3(z)(2).

Orderly trading requirement. The proposed orderly trading requirement is intended to impose on bona fide hedgers a duty of ordinary care when entering, maintaining and exiting the market in the ordinary course of business and in order to avoid as practicable the potential for significant market impact in establishing,

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[275] See, Clarification of Certain Aspect of the Hedging Definition, 52 FR 27195, Jul. 20, 1987 (July 1987 interpretative statement).

[276] 7 U.S.C. 6a(c)(1).

[277] The incidental test was not contained in vacated § 151.5(a)(1). This omission was not discussed in the preambles to the proposed or final rule. However, the incidental test was retained in amended § 1.3(z)(1) for excluded commodities. 76 FR at 71683.

maintaining or liquidating a position in excess of position limitations.[278] The Commission believes the proposed orderly trading requirement is consistent with the policy objectives of position limits to diminish, eliminate or prevent excessive speculation and to ensure that the price discovery function of the underlying market is not disrupted.[279] The Commission believes the orderly trading requirement is particularly important since the Commission intends to set the initial levels of position limits at the outer bound of the range of levels of position limits that may serve to maximize the statutory policy objectives. Thus, bona fide hedgers likely would only need an exemption for extraordinarily large positions.

The Commission believes that negligent trading, practices, or conduct should be a sufficient basis for the Commission to disallow a bona fide hedging exemption. The Commission believes that an evaluation of "orderly trading" should be based on the totality of the facts and circumstances as of the time the person engaged in the relevant trading, practices, or conduct — i.e., the Commission intends to consider whether the person knew or should have known, based on the information available at the time, he or she was engaging in the conduct at issue.

The Commission proposes to apply its policy regarding orderly markets for purposes of the disruptive trading practice prohibitions, to its orderly trading requirement for purposes of position limits. "The Commission's policy is that an orderly market may be characterized by, among other things, parameters such as a rational relationship

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[278] Compare, section 4c(a)(5)(B) of the Act, which makes it unlawful for any person to engage in any trading, practice, or conduct on or subject to the rules of a registered entity that, for example, demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period. 7 U.S.C. 6c(a)(5)(B). Section 4c(a)(6) of the Act authorizes the Commission to promulgate such "rules and regulations as, in the judgment of the Commission, are reasonable necessary to prohibit . . . any other trading practice that is disruptive of fair and equitable trading." 7 U.S.C. 6c(a)(6).

[279] See sections 4a(3)(B)(i) and (iv) of the Act. 7 U.S.C. 6a(3)(B)(i) and (iv).

between consecutive prices, a strong correlation between price changes and the volume of trades, levels of volatility that do not dramatically reduce liquidity, accurate relationships between the price of a derivative and the underlying such as a physical commodity or financial instrument, and reasonable spreads between contracts for near months and for remote months."[280] Further, in fulfilling their duty of ordinary care when entering, maintaining and exiting a position, market participants should assess market conditions and consider how their trading practices and conduct affect the orderly execution of transactions when establishing, maintaining or liquidating a position in excess of a speculative position limit.

d. Requirements and guidance for hedges in an excluded commodity — paragraph (1)

The proposed definition of bona fide hedging position for contracts in an excluded commodity[281] includes the general requirements in the opening paragraph and would require that the position is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise (the "economically appropriate" test) and is either (i) specifically enumerated in paragraphs (3)-(5) of the definition of bona fide hedging position; or (ii) recognized as a bona fide hedging position by a DCM or SEF consistent with the guidance on risk management exemptions in proposed appendix A to part 150.[282]

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[280] See Interpretive Guidance and Policy Statement on Antidisruptive Practices Authority, 78 FR 31890, 31895–96 (May 28, 2013) (available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-12365a.pdf).

[281] "Excluded commodity" is defined in section 1a(19) of the Act. 7 U.S.C. 1a(19).

[282] See the discussion below of proposed § 150.5(b)(5), requiring exchange hedge exemptions to exchange limits on contracts in an excluded commodity to conform to the definition of bona fide hedging position in § 150.1. The Dodd-Frank Act expanded the authority of the Commission with respect to core principles applicable to exchange traded contracts in an excluded commodity, but did not address directly the

The economically appropriate test in section 4a(c)(2) of the Act, applicable to physical commodities, also should apply to excluded commodities because it has long been a fundamental requirement of a bona fide hedging position.[283] Current § 1.3(z)(1) contains the economically appropriate test.[284] The Commission notes that the concept of the reduction of risk was long embodied in the statutory concept of "offset" prior to 1974.[285] The economically appropriate test is discussed further, below.

Under the proposed definition, an exchange would be permitted to grant an exemption based on its rules that were consistent with the enumerated exemptions in paragraphs (3)-(5) of the proposed definition of bona fide hedging position. Current § 1.3(z)(1) also requires a bona fide hedging position to be either (i) an enumerated exemption in current § 1.3(z)(2) or (ii) a non-enumerated exemption under current §

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definition of bona fide hedging positions for excluded commodities. The Dodd-Frank Act amended the core principles for DCMs and established core principles for SEFs, authorizing the Commission, by rule or regulation, to restrict the reasonable discretion of the exchange in complying with core principles. 7 U.S.C. 7(d)(1)(B) and 7b-3(f)(1)(B).

[283] See, e.g., the definition of bona fide hedging promulgated by the Commission's predecessor in § 1.3(z) of its regulations in 1975. 40 FR 11560, 11561, Mar. 12, 1975 ("Bona fide hedging transactions or positions … shall mean sales of or short positions in **any** commodity for future delivery ...,"(emphasis added)).

[284] The Commission adopted this requirement in § 1.3(z)(1) in 1977. 42 FR 42748, 42751, Aug. 24, 1977. Prior to that time, the concept of economically appropriate to the reduction of risk in the operation of a commercial enterprise was not separately articulated, but was reflected in the incidental test ("unless their bona fide purpose is to offset price risks incidental to commercial cash or spot operations") in § 1.3(z)(1) as amended in 1975. 40 FR 11560, 11561, Mar. 12, 1975. Current § 150.5(d) provides guidance to DCMs that exchange regulations for bona fide hedging position exemptions (including exemptions for excluded commodity contracts) should be granted in accordance with current § 1.3(z)(1). 17 CFR 150.5(d) See, for example, Chicago Mercantile Exchange Rule 559.A., Bona Fide Hedging Positions, available at http://www.cmegroup.com/rulebook/CME/I/5/5.pdf, that provides: "The Market Regulation Department may grant exemptions from position limits for bona fide hedge positions as defined by CFTC Regulation §1.3(z)(1). Approved bona fide hedgers may be exempted from emergency orders that reduce position limits or restrict trading."

[285] Prior to 1974, section 4a of the Act defined bona fide hedging transactions as: "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." 7 U.S.C. 6a (1940).

1.3(z)(3) (a non-enumerated exemption may be granted under current § 1.47 as a risk management exemption). The enumerated exemptions in paragraphs (3)-(5) of the proposed definition of bona fide hedging position contain all of the enumerated exemptions in current § 1.3(z)(2). The specifically enumerated exemptions also are discussed separately, below.

The Commission is proposing to incorporate as guidance in appendix A to part 150 the concepts in the 1987 risk management exemptions interpretative statement.[286] The Commission believes that it would be consistent with the objectives of section 4a of the Act for exchange rules to exempt from speculative limits a number of risk management positions in commodity derivative contracts in an excluded commodity. Such risk management exemption positions would include, but not be limited to, three types of exemptions for: (i) unleveraged long positions (covered by cash set aside); (ii) short calls on securities or currencies owned (i.e., covered calls); and (iii) long positions in asset allocation strategies covered by hedged debt securities or currencies owned (i.e., unleveraged synthetic positions).[287] The Commission is proposing to withdraw the 1987 risk management exemption interpretative statement in light of incorporating its concepts in proposed appendix A to part 150, thus rendering that interpretative statement redundant. The Commission requests comment on all aspects of proposed appendix A to part 150.

In addition, under the proposed guidance for excluded commodities and as is currently the case, there need not be any temporary substitute test for a bona fide hedging position in an excluded commodity. This is consistent with the Commission's July 1987

[286] 52 FR 34633, Sep. 14, 1987.

[287] Id. at 34626.

interpretative statement that the temporary substitute component need not apply to a bona fide hedging position in an excluded commodity. [288]

e. Requirements for hedges in a physical commodity — paragraph (2)

The Commission is proposing to implement the statutory directive of section 4a(c)(2) of the Act in paragraph (2) of the proposed definition of bona fide hedging position under § 150.1. The proposed definition for physical commodities would also include the general requirements of the opening paragraph, as is the case under current § 1.3(z)(1) and as discussed above.

Section 4a(c)(2) of the Act directs the Commission to define what constitutes a bona fide hedging position for futures and option contracts on physical commodities listed by DCMs.[289] The Commission proposes to apply the same definition to (i) swaps that are economically equivalent to futures contracts and (ii) direct-access linked FBOT futures contracts that are economically equivalent to futures contracts listed by DCMs. [290] Applying the same definition to economically equivalent contracts would promote administrative efficiency. Applying the same definition to economically equivalent contracts also is consistent with congressional intent as embodied in the expansion of the Commission's authority to apply position limits to swaps (i.e., those that are

[288] 52 FR 27195, Jul. 20, 1987 (July 1987 Interpretative Statement). See also House of Representatives Committee Report quoted at 52 FR 34633, 34634, September 14, 1987, regarding "futures positions taken as alternatives rather than temporary substitutes for cash market positions." H.R. Rep No. 624, 99th Cong., 2d Sess. 1, 45-46 (1986). However, the Commission is proposing to withdraw the July 1987 Interpretative Statement, since the temporary substitute test was added by the Dodd-Frank Act as a statutory requirement for a bona fide hedging position in a physical commodity. 7 U.S.C. 4a(c)(2)(A)(i).

[289] 7 U.S.C. 6a(c)(2).

[290] This is consistent with the approach the Commission took in vacated § 151.5. 76 FR 71643 n.168.

economically equivalent to futures and swaps that serve a significant price discovery function) and to direct-access linked FBOT contracts.[291]

Paragraph (2)(i) of the proposed definition would recognize as bona fide a position in a commodity derivative contract that (i) represents a substitute for positions taken or to be taken at a later time in the physical marketing channel (i.e., the "temporary substitute" test); (ii) is economically appropriate to the reduction of risks (i.e., the "economically appropriate" test); and (iii) arises from the potential change in value of assets, liabilities or services (i.e., the "change in value" requirement), provided the position is enumerated in paragraphs (3) through (5) of the definition, as discussed below. This subparagraph would incorporate the provisions of section 4a(c)(2)(A) of the Act for futures and option contracts and also would include the provisions of section 4a(c)(2)(B)(ii) of the Act, regarding swaps, by using the term commodity derivative contracts, which includes swaps, futures and futures option contracts.

Temporary substitute test. The temporary substitute test requires that a bona fide hedging position must represent "a substitute for . . . positions taken or to be taken at a later time in a physical marketing channel."[292] Paragraph (2)(i) of the proposed definition incorporates the temporary substitute test of section 4a(c)(2)(A)(i) of the Act. The express language of section 4a(c)(2)(A)(i) of the Act requires the temporary substitute test to be a necessary condition for classification of positions in physical commodities as bona fide hedging positions. Section 4a(c)(2)(A) of the Act incorporates many aspects of the general definition of bona fide hedging in current § 1.3(z)(1). However, there are significant differences. Section 4a(c)(2)(A)(i) of the Act does not include the adverb

[291] 7 U.S.C. 6a(a)(5)-(6).

[292] 7 U.S.C. 6a(c)(2)(A)(i).

"normally" to modify the verb "represents" in the phrase "represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel."[293] In addition, Congress provided explicit requirements for recognizing swaps as bona fide hedging positions in section 4a(c)(2)(B), recognizing positions that reduce either the risk of swaps that meet the requirements of section 4a(c)(2)(A) of the Act or swaps that are executed opposite a counterparty whose transaction would qualify as bona fide under section 4a(c)(2)(A) of the Act. The statutory requirements are more stringent than the conditions for swap risk management exemptions the Commission previously granted under § 1.3(z)(3) and § 1.47. As discussed above, the Commission granted risk management exemptions for persons to offset the risk of swaps that did not represent substitutes for transactions or positions in a physical marketing channel, neither by the intermediary nor the counterparty. Thus, positions that reduce the risk of such speculative swaps would no longer meet the requirements for a bona fide hedging transaction or position under the new statutory criteria.

Economically appropriate test. Paragraph (2)(A)(ii) of the proposed definition incorporates the economically appropriate test of section 4a(c)(2)(A)(ii) of the Act. This statutory provision mirrors the provisions in current § 1.3(z)(1). The Commission has provided interpretations and guidance over the years as to the meaning of "economically appropriate" in current § 1.3(z)(1). For example, the Commission has indicated that hedges of processing margins by a processor, such as a soybean processor that establishes

[293] In contrast and as noted above, in current § 1.3(z)(1), the phrase "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" has been termed the "temporary substitute" criterion. (Emphasis added.)

long positions in the soybean contract and short positions in the soybean meal contact and the soybean oil contract, may be economically appropriate.[294]

By way of example, a manufacturer may anticipate using a commodity that it does not own as an input to its manufacturing process; however, the manufacturer expects to change output prices to offset substantially a change in price of the input commodity. For example, processing by a soybean crush operation or a fuel blending operation may add relatively little value to the price of the input commodity. In such circumstances, it would be economically appropriate for the processor to offset the price risks of both the unfilled anticipated requirement for the input commodity and the unsold anticipated production; such a hedge would, for example, fully lock in the value of soybean crush processing. Alternatively, a processor may wish to establish a calendar month hedge solely in terms of the input commodity, to offset the price risk of the anticipated input commodity and to cross-commodity hedge the unsold anticipated production. In such an alternative, a processor has hedged the commercial enterprise's exposure to the value of the input commodity at the expected time of acquisition and to the input commodity's value component of the processed commodity at the expected later time of production and sale. Unfilled anticipated requirements, unsold anticipated production and cross-commodity hedging are also discussed as enumerated hedges, below.

The Commission affirms that gross hedging may be appropriate under certain circumstances, when net cash positions do not measure total risk exposure due to differences in the timing of cash commitments, the location of stocks, and differences in

[294] 52 FR 38914, 38920, Oct. 20, 1987.

grades or types of the cash commodity being hedged.[295] By way of example, a merchant may have sold a certain quantity of a commodity for deferred delivery in the current year (i.e., a fixed-price cash sales contract) and purchased that same quantity of that same commodity for deferred receipt in the next year (i.e., a fixed-price cash purchase contract). Such a merchant would be exposed to value risks in the two cash contracts arising from different delivery periods (that is, from a timing difference). Thus, although the merchant has bought and sold the same quantity of the same commodity, the merchant may elect to offset the price risk arising from the cash purchase contract separately from the price risk arising from the cash sales contract, with each offsetting commodity derivative contract regarded as a bona fide hedging position. However, if such a merchant were to offset only the cash purchase contract, but not the cash sales contract (or vice versa), then it reasonably would appear the offsetting commodity derivative contract would result in an increased value exposure of the enterprise (that is, the risk of changes in the value of the cash commodity contract that was not offset is likely to be higher than the risk of changes in the value of the calendar spread difference between the nearby and deferred delivery period) and, so, the commodity derivative contract would not qualify as a bona fide hedging position.

In order for a position to be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, the enterprise generally should take into account all inventory or products that the enterprise owns or controls, or has contracted for purchase or sale at a fixed price. For purposes of reporting cash market positions under current part 19, the Commission historically has allowed a reporting

[295] 42 FR 14832, 14834, Mar. 16, 1977.

trader to "exclude certain products or byproducts in determining his cash positions for bona fide hedging" if it is "the regular business practice of the reporting trader" to do so.[296] The Commission has determined to clarify the meaning of "economically appropriate" in light of this reporting exclusion of certain cash positions.

Originally, the Commission intended for the optional part 19 reporting exclusion to cover only cash positions that were not capable of being delivered under the terms of any derivative contract.[297] The Commission differentiated between "products and byproducts" of a commodity and the underlying commodity itself, the former capable of exclusion from part 19 reporting under normal business practices due to the absence of any derivative contract in such product or byproduct.[298] This intention ultimately evolved to allow cross-commodity hedging of products and byproducts of a commodity that were not necessarily deliverable under the terms of any derivative contract.[299]

The instructions to current Form 204 go a step further than current § 19.00(b)(1) by allowing for a reporting trader to exclude "certain source commodities, products, or byproducts in determining [] cash positions for bona fide hedging." (Emphasis added.)

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[296] See current § 19.00(b)(1) (providing that "[i]f the regular business practice of the reporting trader is to exclude certain products or byproducts in determining his cash position for bona fide hedging . . . , the same shall be excluded in the report"). 17 CFR 19.00(b)(1).

[297] 43 FR 45825, 45827, Oct. 4, 1978 (explaining that the allowance for eggs not kept in cold storage to be excluded from reporting a cash position in eggs under part 19 "was appropriate when the only futures contract being traded in fresh shell eggs required delivery from cold storage warehouses.").

[298] See id. Prior to the Commission's revision of the part 19 reporting exclusion for eggs, the exclusion allowed "eggs not in cold storage **or certain egg products**" not to be reported as a cash position. 26 FR 2971, Apr. 7, 1961 (emphasis added). Additionally, the title to the revised exclusion read, "Excluding products or byproducts of the cash commodity hedged." See 43 FR 45825, 45828 (Oct. 4, 1978). So, in addition to a commodity itself that was not deliverable under any derivative contract, the Commission also recognized a separate class of "products and byproducts" that resulted from the processing of a commodity that it did not believe at the time were capable of being hedged by any derivative contract for purposes of a bona fide hedge.

[299] See 42 FR 42748, Aug. 24, 1977. Cross-commodity hedging is discussed as an enumerated hedge, below.

In line with its historical approach to the reporting exclusion, the Commission does not believe that it would be economically appropriate to exclude large quantities of a source commodity held in inventory when an enterprise is calculating its value at risk to a source commodity and it intends to establish a long derivatives position as a hedge of unfilled anticipated requirements. As explained in the revisions to part 19, discussed below, a source commodity itself can only be excluded from a calculation of a cash position if the amount is de minimis, impractical to account for, and/or on the opposite side of the market from the market participant's hedging position.

Change in value requirement. Paragraph (2)(A)(iii) of the proposed definition incorporates the potential change in value requirement of section 4a(c)(2)(A)(iii) of the Act. This statutory provision largely mirrors the provisions in current § 1.3(z)(1).[300] The Commission notes that it uses the term "price risk" to mean a "potential change in value." To satisfy the change in value requirement, the purpose of a bona fide hedge must be to offset price risks incidental to a commercial enterprise's cash operations. The change in value requirement is embedded in the concept of offset of price risks.

Pass-through Swaps and Offsets. Subparagraph (2)(B) of the proposed definition would recognize as bona fide 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 under subparagraph (2)(A). This provision generally mirrors the provisions of section

[300] Compare 7 U.S.C. 6a(c)(2)(A)(iii) and 17 CFR 1.3(z)(1). Note that § 1.3(z)(1)(ii) uses the phrase "liabilities which a person **owes** or anticipate incurring," while section 4a(c)(2)(A)(iii)(II) uses the phrase "liabilities that a person **owns** or anticipates incurring." (Emphasis added.) The Commission interprets the word "owns" to be an error and the word "owes" to be correct.

4a(c)(2)(B)(i) of the Act,[301] and clarifies that the swap itself is also a bona fide hedging position to the extent it is offset. However, the Commission is proposing that it will not recognize as bona fide hedges the offset of such swaps with physical-delivery contracts during the lesser of the last five days of trading or the time period for the spot month in such physical-delivery commodity derivative contract (the "five-day" rule).

The Commission is proposing to use its exemptive authority under section 4a(a)(7) of the Act to net positions in futures, futures options, economically equivalent swaps and direct-access linked FBOT contracts in the same referenced contract for purposes of single month and all-months-combined limits under proposed § 150.2, discussed below.[302] Thus, a pass-through swap exemption would not be necessary for a swap portfolio in referenced contracts that would automatically be netted with futures and futures options in the same referenced contract outside of the spot month under the proposed rules. The Commission historically has permitted non-enumerated risk management positions under § 1.3(z)(3) and § 1.47. Almost all exemptions historically requested and granted under these provisions were for risk management of swap positions related to the agricultural commodities subject to federal position limits under part 150.

As noted above, the proposed rule would impose a five-day rule during the spot-month. In the risk management exemptions for swaps issued to date by the Commission under current § 1.3(z)(3) and § 1.47, the exemptions for swap offsets did not run to the

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[301] The Commission interprets the statutory provision that requires that "the transaction would qualify as a bona fide hedging transaction" to mean the swap position at the time of the transaction would qualify as a bona fide hedging position. 7 U.S.C. 6a(c)(2)(B)(i).

[302] This is consistent with netting permitted in vacated § 151.4(b) of swaps with futures for purposes of single-month and all-months-combined limits. The Commission noted in that final rulemaking that it did "not believe that including a risk management provision is necessary or appropriate given that the elimination of the class limits outside of the spot-month will allow entities, including swap dealers, to net Referenced Contracts whether futures or economically equivalent swaps." 76 FR at 71644.

spot month. As discussed above, the Commission has long imposed a five-day rule in current § 1.3(z)(2) for other exemptions. For example, for hedges of unfilled anticipated requirements, the Commission observed that historically there was a low utilization of this provision in terms of actual positions acquired in the futures market.[303] For cross-commodity and short anticipatory hedge positions, the Commission did not believe that persons who do not possess or do not have a commercial need for the commodity for future delivery will normally wish to participate in the delivery process.[304] In the instant cases of swaps, the Commission has observed generally low usage among all traders of the physical-delivery futures contract during the spot month, relative to the existing exchange spot-month position limits.[305] The Commission invites comments as to the extent to which traders actually have offset the risk of swaps during the spot month in a physical-delivery futures contract with a position in excess of an exchange's spot-month position limit.

The Commission has reviewed its historical policy position regarding the five-day rule for speculative limits in the spot month in light of position information, including positions in physical-delivery energy futures contracts.[306] For example, the Commission

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[303] 42 FR 42748, Aug. 24, 1977.

[304] Id. 42749.

[305] Compare 76 FR at 71690. Vacated § 151.5(a)(2)(3) recognized a pass-through swap offset during the spot period as an exception to the five-day rule if the "pass-through swap position continues to offset the cash market commodity price risk of the bona fide hedging counterparty." Based on a review of open positions in physical-delivery futures contracts, the Commission no longer believes it necessary to recognize offsets of swaps in the last few days of the expiring physical-delivery contract and has not provided this additional provision in the current proposal. Rather, the Commission has decided to forego this exception to the five-day rule in the interest of ensuring that the price discovery function of the underlying market is not disrupted during the last few days of the spot period. Further, the Commission believes it would have been administratively burdensome for a trader to demonstrate that its counterparty continued to have a bona fide hedging need through the spot period.

[306] The Commission also relies upon the congressional shift evidenced in the Dodd-Frank Act amendments to the CEA, that directed the Commission, to the maximum extent practicable, in its discretion, (i) to diminish, eliminate, or prevent excessive speculation, (ii) to deter and prevent market manipulation,

reviewed three years of confidential large trader data in cash-settled and physical-delivery energy contracts. The review covered actual positions held in the physical-delivery energy futures markets during the three-day spot period, among all traders (including those who had received hedge exemptions from their DCM). It showed that, historically, there have been relatively few positions held in excess (and those few not greatly in excess) of the spot month limits. Accordingly, the Commission generally is not inclined to change its long-held policy views regarding physical-delivery futures contracts at this time.[307]

The Commission typically does not publish "general statistical information"[308] regarding large trader positions in the expiring physical-delivery energy futures contracts because of concerns that such data may reveal information about the amount of market power a person may need to "mark the close"[309] or otherwise manipulate the price of an expiring contract.[310]

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squeezes, and corners, (iii) to ensure sufficient market liquidity for bona fide hedgers, and (iv) to ensure that the price discovery function of the underlying market is not disrupted. 7 U.S.C. 6a(a)(3)(B). The five-day rule would serve to prevent excessive speculation as a physical-delivery contract nears expiration, thereby deterring or preventing types of market manipulations such as squeezes and corners and protecting the price discovery function of the market. The restriction of the five-day rule does not appear to deprive the market of sufficient liquidity for bona fide hedgers.

[307] Nevertheless, the Commission requests comment on whether the five-day rule should be waived for pass-through swaps and offsets in the event a position of the bona fide counterparty in the physical-delivery futures contract would have been recognized as a bona fide hedging position. If so, should a person be required to document the continuing bona fides of the counterparty to such swaps through the spot period, that is, in addition to the time of the transaction? Further, should a person also be required to have an unfixed-price forward contract with the bona fide counterparty, so that a person would have a bona fide need and ability to make or take delivery on the physical-delivery futures contract, analogous to the agent provisions in proposed paragraph (3)(iv) of the definition of bona fide hedging position?

[308] As authorized by CEA section 8(a)(1). 7 U.S.C. 12(a)(1).

[309] Marking the close refers to, among other things, the practice of acquiring a substantial position leading up to the closing period of trading in a futures contract, followed by offsetting the position before the end of the close of trading, in an attempt to manipulate prices in the closing period.

[310] The Commission gathers large trader position reports on reportable traders in futures under part 17 of the Commission's rules. That data has historically remained confidential pursuant to CEA section 8. The

f. Trade option exemption

The Commission previously amended part 32 of its regulations to allow commodity options to trade subject to the same rules applicable to any other swap, unless the commodity option qualifies under the new § 32.3 trade option exemption.[311] In order to qualify for the trade option exemption, (i) both offeror and offeree must be a producer, processor, or commercial user of, or merchant handling the commodity that is the subject of the commodity option transaction, or the products or byproducts thereof, and both offeror and offeree must be offering or entering into the commodity option transaction solely for purposes related to their business as such,[312] and (ii) the option is intended to be physically settled such that, if exercised, the commodity option would result in the sale of an exempt or agricultural commodity for immediate or deferred shipment or delivery.[313] Qualifying trade options are exempt from all requirements of the CEA and Commission's regulations, except for certain enumerated provisions, including position limits.[314]

The Commission is making conforming changes to the trade option exemption requirement that position limits still apply. Under § 32.3(c)(2), "Part 151 (Position

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Commission does, however, publish summary statistics for all-months-combined in its Commitments of Traders Report, available on http://www.cftc.gov/MarketReports/CommitmentsofTraders/index.htm.

[311] See 17 CFR 32.2; Commodity Options, 77 FR 25320 (Apr. 27, 2012).

[312] Additionally, the offeror can be an eligible contract participant ("ECP") as defined in CEA section 1a(18).

[313] The Commission noted in the preamble to the trade option exemption that in determining delivery intent, market participants could refer to the guidance provided for the forward contract exclusion in the Product Definition rulemaking. See 77 FR at 25326. This guidance conveyed that the Commission's "Brent Interpretation" is equally applicable to the forward exclusion from the swap definition as it was to the forward exclusion from the "future delivery" definition, which allows for subsequently, separately negotiated book-out transactions to qualify for the forward contract exclusion. See 77 FR 48208, 48228, Aug. 13, 2012 (citing Statutory Interpretation Concerning Forward Transactions, 55 FR 39188, Sep. 25, 1990).

[314] See 17 CFR 32.3(b)-(d).

Limits)" of the Commission's regulations applies to every counterparty to a trade option "to the same extent that [part 151] would apply to such person in connection with any other swap." The Commission is replacing the reference to "Part 151," now vacated, with "Part 150" to clarify that the position limit requirements proposed herein still would be applicable to trade options qualifying under the exemption.

The Commission also is requesting comment as to whether the Commission should use its exemptive authority under CEA section 4a(a)(7)[315] to provide that the offeree of a commodity option qualifying for the trade option exemption would be presumed to be a "pass-through swap counterparty" for purposes of the offeror of the trade option qualifying for the pass-through swap offset.[316] Although the Commission is proposing generally to net futures and swaps in reference contracts in the same commodity under proposed § 150.2, as discussed below, the Commission notes that cross-commodity offsets of pass-through swaps would not be recognized unless the counterparty to the swap is a bona fide hedger. Would this presumption help offerors determine the appropriateness of carrying out cross-commodity hedge transactions?

In addition, the Commission requests comments on whether adopting such a presumption might allow use of the exemption to evade Commission rules pertaining to swap transactions. Should the Commission adopt an anti-evasion provision to address this concern? Furthermore, might some additional safeguards be included to allow the Commission to provide administrative simplicity through use of the presumption, while also limiting use of the presumption to evade other regulations?

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[315] 7 U.S.C. 6a(a)(7).

[316] See the proposed § 150.1 definition of "bona fide hedge exemption" at paragraph (2)(ii).

Further, the Commission requests comment on whether it would be appropriate to exclude trade options from the definition of referenced contracts and, thus, to exempt trade options from the proposed position limits. If trade options were excluded from the definition of reference contracts, then commodity derivative contracts that offset the risk of trade options would not automatically be netted with such trade options for purposes of non-spot month position limits. The Commission notes that forward contracts are not subject to the proposed position limits; however, certain forward contracts may serve as the basis of a bona fide hedging position exemption, e.g., an enumerated bona fide hedging position exemption is available for the offset of the risk of a fixed price forward contract with a short futures position. Should the Commission include trade options as one of the enumerated exemptions (e.g., proposed paragraphs (3)(ii) and (iii) of the definition of bona fide hedging position under proposed § 150.1)? As an alternative to excluding trade options from the definition of referenced contract, should the Commission provide an exemption under CEA section 4a(a)(7) that permits the offeree or offeror to submit a notice filing to exclude their trade options from position limits? If so, why and under what circumstances? Are there any other characteristics of trade options or the parties to trade options that the Commission should consider? Would any of these alternatives permit commodity options that should be regulated as swaps to circumvent the protections established in the Dodd-Frank Act for the forward contract exclusion for non-financial commodities?

g. Enumerated hedges — paragraphs (3)-(5).

Proposed paragraph (1)(i) would require a bona fide hedging position in an excluded commodity to be enumerated under paragraphs (3), (4) or (5) of the definition

or to be granted an exemption under exchange rules consistent with the risk management guidance of appendix A to part 150. Proposed paragraph (2)(i)(D) would require a bona fide hedging position in a physical commodity to be enumerated under paragraphs (3), (4) or (5) of the definition. The Commission has historically enumerated acceptable bona fide hedging positions in § 1.3(z)(2) for physical commodities. Each of the enumerated provisions is discussed below. For convenience, the Commission is providing a summary comparison of the various provisions of the proposed rule, vacated part 151, and current rules, in Table 4 below.

Table 4. Proposed, Current, and Vacated Enumerated Bona Fide Hedges

Cash position underlying bona fide hedging position	Paragraph in proposed definition of bona fide hedging position under § 150.1 and related provisions	Current § 1.3(z) and related provisions	Vacated part 151 definition
Inventory and fixed-price cash commodity purchase contracts	(3)(i)	1.3(z)(2)(i)(A)	151.5(a)(2)(i)(A)
Fixed-price cash commodity sales contracts	(3)(ii)	1.3(z)(2)(ii)(A) and (B)	151.5(a)(2)(ii)(A) and (B)
Unfilled anticipated requirements for same cash commodity	(3)(C)(i)	1.3(z)(2)(ii)(C)	151.5(a)(2)(ii)(C)
Unfilled anticipated requirements for resale by a utility	(3)(C)(ii)	N/A	N/A
Hedges by agents	(3)(iv)	1.3(z)(3) Discussed as example of non-enumerated hedge	151.5(a)(2)(iv)
Unsold anticipated production	(4)(i)	1.3(z)(2)(i)(B)	151.5(a)(2)(i)(B)
Offsetting unfixed-price cash	(4)(ii) Scope expanded in	1.3(z)(2)(iii)	151.5(a)(2)(iii)

commodity sales and purchases	comparison to part 151		
Anticipated royalties	(4)(iii) Scope reduced in comparison to part 151 to ownership of royalties	N/A	151.5(a)(2)(vi)
Services	(4)(iv)	N/A	151.5(a)(2)(vii)
Cross-commodity hedges	(5) Scope expanded to permit cross-hedge of pass-through swap in comparison to part 151	1.3(z)(2)(iv)	151.5(a)(2)(viii)
Pass-through swap offset	(2)(ii)(A)	1.3(z)(3) and 1.47 Non-enumerated exemption for futures used in risk management of swaps	151.5(a)(3)
Pass-through swap	(2)(ii)(B)	N/A, as not subject to current federal limits	151.5(a)(4)
Non-enumerated hedges	150.3(e)	1.3(z)(3) and 1.47	151.5(a)(5)
Filing for anticipatory hedges	150.7	1.3(z) and 1.48	151.5(d)

N/A denotes not applicable.

For clarity, the proposed definition uses the terms long positions and short positions in commodity derivative contracts as those terms are proposed to be defined, rather than the terms purchases or sales of any commodity for future delivery, used in current § 1.3(z)(2). These clarifications are for two reasons. First, the proposed definition only addresses bona fide hedging positions, and does not address bona fide hedging transactions. Although the language of current § 1.3(z)(2) was written to address purchase or sales transactions, the Commission eliminated daily speculative trading

volume limits in 1979, as noted above.[317] The Commission and its predecessor has long interpreted the terms sales or purchases of futures contracts in § 1.3(z)(2) to mean short or long positions in futures contracts in the context of position limits.[318] Second, the proposed definition would be applicable to positions in commodity derivative contracts (i.e., futures, options thereon, swaps and direct-access linked FBOT contracts) rather than only to futures and options contracts. As noted above, the Commission preliminarily believes it appropriate to apply the same definition of bona fide hedging positions to all physical commodity derivative contracts subject to federal limits.

The Commission notes that DCMs and SEFs may impose additional conditions on holders of positions in commodity derivative contracts, particularly in the spot month. The Commission has long relied on the DCMs to protect the integrity of the exchange's delivery process in physical-delivery contracts. Congress recognizes this obligation, including in core principle 5, which requires DCMs to consider position limitations or position accountability for speculators to reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month.[319]

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[317] 44 FR 7124, Feb. 6, 1979.

[318] The statutory definition of bona fide hedging in section 4a(3) of the Act (prior to the CFTC Act of 1974) used the terms "sales of any commodity for future delivery . . . to the extent that such sales are offset in quantity by the ownership or purchase of the same cash commodity" and "purchases of any commodity for future delivery . . . to the extent that such purchases are offset by sales of the same cash commodity." 7 U.S.C. 6a(3) (1940). Following enactment of the CFTC Act, the Secretary of Agriculture's initial proposed definition of bona fide hedging transactions or positions makes clear this understanding, as that definition provided, in relevant part, for "sales of, or short positions in any commodity for future delivery . . . to the extent that such sales or short positions are offset in quantity by the ownership or fixed-price purchase of the same cash commodity" and for "purchases of, or long positions in, any commodity for future delivery . . . to the extent that such purchases or long positions are offset by fixed-price sales of the same cash commodity. . . ." 39 FR 39731, Nov. 11, 1974. The Commission adopted that same language in its initial definition of bona fide hedging transactions or positions. 40 FR 48688, 48689, Oct. 17, 1975. In both the proposed and final rules in 1977, the Commission was silent as to why it omitted the clarifying phrases "long positions" and "short positions." Proposed Rule, 42 FR 14832, Mar. 16, 1977; Final Rule, 42 FR 42748, Aug. 24, 1977.

[319] 7 U.S.C. 7(d)(5).

Exchanges will typically impose on large short position holders in a physical-delivery contract a continuing obligation to compare cash market and futures market prices in the spot month and to liquidate the derivative position (i.e., buy back the short position) if the commodity may be sold at a more favorable (higher) price in the cash market. Further, exchanges will typically impose on large long position holders in a physical-delivery contract a continuing obligation to compare cash market and futures market prices in the spot month and to liquidate the derivative position (i.e., sell the long position) if the commodity may be purchased at a more favorable (lower) price in the cash market. Exchanges can continue these practices under the proposed rule.

1) Exemption-by-exemption discussion

Inventory and cash commodity purchase contracts—paragraph (3)(A). Inventory and fixed-price cash commodity purchase contracts have long served as the basis of a bona fide hedging position.[320] This provision is in current § 1.3(z)(2)(i)(A). A commercial enterprise is exposed to price risk if it has (i) obtained inventory in the normal course of business or (ii) entered into a fixed-price purchase contract, whether spot or forward, calling for delivery in the physical marketing channel of a commodity; and has not offset that price risk. For example, an enterprise may offset such price risk in the cash market by entry into fixed-price sales contracts. An appropriate hedge of inventory or a fixed-price purchase contract would be to establish a short position in a commodity derivative contract to offset the risk of such position. Such short position

[320] See, e.g., 7 U.S.C 6a(3) (1970). That statutory definition of bona fide hedging included "sales of, or short positions in, any commodity for future delivery on or subject to the rules of any contract market made or held by such person to the extent that such sales or short positions are offset in quantity by the ownership or purchase of the same cash commodity by the same person."

may be held into the spot month in a physical-delivery contract if economically appropriate.[321]

A person can use a commodity derivative contract to hedge inventories of a cash commodity that is deliverable on that physical-delivery contract. Such a deliverable cash commodity inventory need not be in a delivery location. However, the Commission notes that a DCM or SEF may prudentially require such short positions holders to demonstrate the ability to move the commodity into a deliverable location, particularly during the spot month.[322]

Once inventory has been sold, a person is permitted a commercially reasonable time period, as necessary to exit the market in an orderly manner, to liquidate a position in commodity derivative contracts in excess of a position limit. Generally, the Commission believes such time period would be less than one business day.

Cash commodity sales contracts—paragraph (3)(B). Fixed-price cash commodity sales have long served as the basis of a bona fide hedging position.[323] This provision is in current § 1.3(z)(2)(ii)(A) and (B). A commercial enterprise is exposed to price risk if it has entered into a fixed-price sales contract, whether spot or forward, calling for delivery in the physical marketing channel of a commodity and has not offset that price risk, for

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[321] For example, it would not appear to be economically appropriate to hold a short position in the spot month of a commodity derivative contract against fixed-price purchase contracts that provide for deferred delivery in comparison to the delivery period for the spot month commodity derivative contract. This is because the commodity under the cash contract would not be available for delivery on the commodity derivative contract.

[322] Further, the Commission notes an exchange, pursuant to its position accountability rules, may at any time direct a trader that is in excess of accountability levels to reduce a position in a contract traded on that exchange.

[323] See, e.g., 7 U.S.C 6a(3) (1970). That statutory definition of bona fide hedging included "purchases of, or long positions in, any commodity for future delivery on or subject to the rules of any contract market made or held by such person to the extent that such purchases or long positions are offset by sales of the same cash commodity by the same person."

example, by entering into a fixed-price purchase contract. An appropriate hedge of a fixed-price sales contract would be to establish a long position in a commodity derivative contract to offset the risk of such cash market contact. Such long position may be held into the spot month in a physical-delivery contract if economically appropriate.

Unfilled anticipated requirements—paragraph (3)(C)(i). Unfilled anticipated requirements for the same cash commodity have long served as the basis of a bona fide hedging position.[324] This provision mirrors the requirement of current § 1.3(z)(2)(ii)(C). An appropriate hedge of unfilled anticipated requirements would be to establish a long position in a commodity derivative contract to offset the risk of such unfilled anticipated requirements.

Under the proposal, such long positions may not be held into the lesser of the last five days of trading or the time period for the spot month in a physical-delivery commodity derivative contract (the five-day rule), with the exception that a person may hold long positions that do not exceed the person's unfilled anticipate requirements of the same cash commodity for the next two months. As noted above, the CME Group and the Working Group pointed out that previously, persons engaged in purchases of futures contracts have been permitted to hold up to twelve months unfilled anticipated requirements of the same cash commodity for processing, manufacturing, or feeding by the same person, provided that such transactions and positions in the five last trading

[324] See, e.g.,7 U.S.C 6a(3)(C) (1970). That statutory definition of bona fide hedging included "an amount of such commodity the purchase of which for future delivery shall not exceed such person's unfilled anticipated requirements for processing or manufacturing during a specified operating period not in excess of one year: Provided, That such purchase is made and liquidated in an orderly manner and in accordance with sound commercial practice in conformity with such regulations as the Secretary of Agriculture may prescribe."

days of any one futures do not exceed the person's unfilled anticipated requirements of the same cash commodity for that month and for the next succeeding month.

Utility hedging unfilled anticipated requirements of customers—paragraph (3)(iii)(B). The Commission is proposing a new exemption for unfilled anticipated requirements for resale by a utility. This provision is analogous to the unfilled anticipated requirements provision of paragraph (3)(iii)(A), except the commodity is not for use by the same person—that is, the utility— but rather for anticipated use by the utility's customers. The proposed new exemption would recognize a bona fide hedging position where a utility is required or encouraged to hedge by its public utility commission ("PUC").

Request Six of the Working Group petition asked the Commission to grant relief with respect to a long position in a commodity derivative contract that arises from natural gas utilities' desire to hedge the price of gas that they expect to purchase and supply to their retail customers. In support of its petition, the Working Group provided evidence that hedging natural gas price risk, which includes some combination of fixed-price supply contracts, storage and derivatives, is a prudent risk management practice that limits volatility in the prices ultimately paid by consumers.[325]

Materials submitted in support of the Working Group petition[326] make it clear that the risk management transactions — fixed-price contracts, storage, and derivatives — engaged in by a typical natural gas utility to reduce risk associated with anticipated

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[325] See, e.g., "Use of Hedging by Local Gas Distribution Companies: Basic Considerations and Regulatory Issues," K. Costello and J. Cita, The National Regulatory Research Institute at the Ohio State University (May 2001). All supporting materials provided by the Working Group are available at http://sirt.cftc.gov/sirt/sirt.aspx?Topic=CommissionOrdersandOtherActionsAD&Key=23082.

[326] Id.

requirements of natural gas are used to fulfill its obligation to serve retail customers and are typically considered by the state PUC as prudent. The PUC may indeed obligate the natural gas utility to hedge some portion of the supply of natural gas needed to meet the needs of its customers and may take regulatory action if the utility fails to do so. As a result, in order to mitigate the impact of natural gas price volatility on the cost of natural gas acquired to serve its regulated retail natural gas customers, a utility may enter into long positions in commodity derivative contracts to hedge a specified percentage of such customers' anticipated natural gas requirements over a multi-year horizon. The utility's PUC considers such hedging practices to be prudent and has allowed gains and losses related to such hedging activities to be retained by its regulated retail natural gas customers.

The Commission recognizes the highly regulated nature of the natural gas market, where state-regulated public utilities may have rules or guidance concerning locking in the costs of anticipated requirements for retail customers through a number of means, including fixed-price purchase contracts, storage, and commodity derivative contracts. Moreover, since the public utility typically does not directly profit from the results of its hedging activity (because most or all of the gains derived from hedging are passed on to customers, e.g., through the price charged for natural gas), the utility has no incentive to speculate.

The Commission invites comments on all aspects of this new enumerated bona fide hedging exemption.

Hedges by agents—paragraph (3)(iv). The Commission is proposing an enumerated exemption for hedges by an agent who does not own or has not contracted to

sell or purchase the offsetting cash commodity at a fixed price, provided that the agent is responsible for merchandising the cash positions that are being offset in commodity derivative contracts and the agent has a contractual arrangement with the person who owns the commodity or holds the cash market commitment being offset. The Commission historically has recognized a merchandising transaction as a bona fide hedge in the narrow circumstances of an agent responsible for merchandising a cash market position which is being offset.[327]

Other enumerated hedging positions—paragraph (4). Each of the other enumerated hedging positions would be subject to the five-day rule for physical-delivery contracts. The Commission reiterates the intent of the five-day rule is to protect the integrity of the delivery process in physical-delivery contracts. The reorganization into new paragraph (4) of existing provisions in 1.3(z) subject to the five-day rule is intended for administrative ease.

Unsold anticipated production—paragraph (4)(i). Unsold anticipated production has long served as the basis of a bona fide hedging position.[328] This provision is in current § 1.3(z)(2)(i)(B). The Commission historically has recognized twelve months of unsold anticipated production in an agricultural commodity as the basis of a bona fide hedging position. Under the proposal, this twelve-month restriction would not apply to physical-delivery contracts that were not in an agricultural commodity.

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[327] This provision is included in current § 1.3(z)(3) as an example of a potential non-enumerated case. 17 CFR 1.3(z)(3). Compare vacated § 151.5(a)(2)(iv).

[328] See 7 U.S.C 6a(3)(A) (1940). That statutory definition of bona fide hedging, enacted in 1936, included "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."

The Commission is considering relaxing the five-day rule to permit a person to hold a position in a physical-delivery commodity derivative contract, other than in an agricultural commodity, through the close of the spot month that does not exceed in quantity the reasonably anticipated unsold forward production that would be available for delivery under the terms of a physical-delivery commodity derivative contract. For example, a person with a significant number of producing natural gas wells may be highly certain that she can be a position to deliver natural gas on the physical-delivery natural gas futures contract.[329] The Commission is considering permitting the exchange listing the physical-delivery commodity derivative contract to administer exemptions to the five-day rule upon application to such exchange specifying the unsold forward production that could be moved into delivery position. The Commission requests comment on this alternative.

Offsetting unfixed-price cash commodity sales and purchases — paragraph (4)(ii). Offsetting unfixed-price cash commodity sales and purchases basis different delivery months in the same commodity derivative contract have long served as the basis of a bona fide hedging position.[330] This provision is in current § 1.3(z)(2)(iii). The Commission explained a major rationale for this exemption for spread positions was to facilitate commercial risk shifting positions which may not have otherwise conformed to the definition of bona fide hedging.[331]

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[329] In contrast, prior to harvest, a farmer must plant and manage a crop until it is ripe. Anticipated agricultural production may not be available timely at a delivery location for a futures contract. Thus, historically, only inventories of agricultural commodities, rather than anticipated production, have been recognized as a basis for a bona fide hedging position under the five-day rule.

[330] The Commission added this enumerated exemption to the definition of bona fide hedging in 1987. 52 FR 38914, Oct. 20, 1987.

[331] 51 FR 31648, 31650, September 4, 1986. "In particular, a cotton merchant may contract to purchase and sell cotton in the cash market in relation to the futures price in different delivery months for cotton, i.e.,

The proposed enumerated provision would be expanded from current § 1.3(z)(2)(iii) to include unfixed-price cash contracts basis different commodity derivative contracts in the same commodity, regardless of whether the commodity derivative contracts are in the same calendar month.[332] The Commission notes a commercial enterprise may enter into the described transactions to reduce the risk arising from either (or both) a location differential or a time differential in unfixed price purchase and sale contracts in the same cash commodity.[333] The contemplated derivative transactions represent a substitute for two transactions to be made at a later time in a physical marketing channel: a fixed-price purchase and a fixed-price sale of the same cash commodity. The commercial enterprise intends to later take delivery on one unfixed-price cash contract and to re-deliver the same cash commodity on another unfixed-price cash contract. There may be no substantive difference in time between taking and making delivery in the physical marketing channel, but the derivative contracts do not offset each other because they are in two different contracts (e.g., the NYMEX Light Sweet Crude Oil futures contract versus the ICE Europe Brent crude futures) or two different instruments (e.g., swaps versus futures). The contemplated derivative positions will offset the risk that the difference in the expected delivery prices of the two unfixed-price cash contracts in the same commodity will change between the time the hedging transaction is entered and the time of fixing of the prices on the purchase and sales cash

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a basis purchase and a basis sale. Prior to the time when the price is fixed for each leg of such a cash position, the merchant is subject to a variation in the two futures contracts utilized for price basing. This variation can be offset by purchasing the future on which the sales were based [and] selling the future on which [the] purchases were based." Id. (n. 3).

[332] The Working Group requested this expansion in Requests One and Two.

[333] A location differential is the difference in price between two derivative contracts in the same commodity (or substantially the same commodity) at two different delivery locations on the same (or similar) delivery dates. A location differential also may underlie a single derivative contract that is called a basis contract.

contracts. Therefore, the contemplated derivative positions are economically appropriate to the reduction of risk.

In the case of reducing the risk of a location differential, and where each of the underlying transactions in separate derivative contracts may be in the same contract month, the Commission notes that a position in a basis contract would not be subject to position limits, as discussed in the proposed definition of referenced contract.

The Commission notes that upon fixing the price of, or taking delivery on, the purchase contract, the owner of the cash commodity may hold the short derivative leg of the spread as a hedge against a fixed-price purchase or inventory.[334] However, the long derivative leg of the spread would no longer qualify as a bona fide hedging position since the commercial entity has fixed the price or taken delivery on the purchase contract. Similarly, if the commercial entity first fixed the price of the sales contract, the long derivative leg of the spread may be held as a hedge against a fixed-price sale,[335] but the short derivative leg of the spread would no longer qualify as a bona fide hedging position.

Anticipated royalties—paragraph (4)(iii). The new enumerated exemption would permit an owner of a royalty to lock in the price of anticipated mineral production. The Commission initially recognized the hedging of anticipated royalties in vacated § 151.5(a)(2)(vi).[336] That provision would have recognized "sales or purchases" in commodity derivative contracts that would be "offset by the anticipated change in value of royalty rights that are owned by the same person . . . [and] arise out of the production, manufacturing, processing, use, or transportation of the commodity underlying the

[334] See proposed paragraph (3)(i) of the definition of bona fide hedging position under § 150.1.

[335] See proposed paragraph (3)(ii) of the definition of bona fide hedging position under § 150.1.

[336] 76 FR at 71689.

[commodity derivative contract], which may not exceed one year for agricultural" commodity derivative contracts; such positions would be subject to the five-day rule.

The Commission has reconsidered that exemption in vacated § 151.5(a)(2)(vi) and now re-proposes it as an enumerated exemption for short positions in commodity derivative contracts offset by the anticipated change in value of mineral royalty rights that are owned by the same person and arise out of the production of a mineral commodity (e.g., oil and gas); such positions would be subject to the five-day rule. This proposed exemption differs from the exemption in vacated § 151.5(a)(2)(vi) because it applies only to: (i) short positions; (ii) arising from production; and (iii) in the context of mineral extraction.

A royalty arises as "compensation for the use of property . . . [such as] natural resources, expressed as a percentage of receipts from using the property or as an account per unit produced."[337] A short position is the proper offset of a yet-to-be received payment based on a percentage of receipts per unit produced for a royalty that is owned. This is because a short position fixes the price of the anticipated receipts, removing exposure to change in value of the person's share of the production revenue.[338] In contrast, a person who has issued a royalty has, by definition, agreed to make a payment in exchange for value received or to be received (e.g., the right to extract a mineral). Upon extraction of a mineral and sale at the prevailing cash market price, the issuer of a

[337] Black's Law Dictionary, 6th Ed.

[338] A short position fixes the price at the entry price to the commodity derivative contract. For any decrease (increase) in price of the commodity produced, the expected royalty would decline (increase) in value, but the commodity derivative contract would increase (decrease) in value, offsetting the price risk in the royalty.

royalty remits part of the proceeds in satisfaction of the royalty agreement. Thus, the issuer of a royalty does not have price risk arising from that royalty agreement.

The Commission preliminarily believes that "manufacturing, processing, use, or transportation" of a commodity does not conform to the meaning of the term royalty. Further, while the Commission recognizes that, historically, royalties have been paid for use of land in agricultural production,[339] the Commission has not received any evidence of a need for a bona fide hedging exemption from owners of agricultural production royalties. The Commission nonetheless invites comment on all aspects of this new royalty exemption.

Services—paragraph (4)(iv). The Commission is proposing the hedging of services as a new enumerated hedge in subparagraph (4)(iv) of the proposed definition. This new exemption is not without Commission precedent. For example, in 1977, the Commission noted that the existence of futures markets for both source and product commodities, such as soybeans and soybean oil and meal, afford business firms increased opportunities to hedge the value of services.[340] The Commission's current proposal is similar to vacated § 151.5(a)(2)(vii).[341] That provision would have recognized "sales or purchases" in commodity derivative contracts that would be "offset by the anticipated change in value of receipts or payments due or expected to be due under an executed contract for services held by the same person . . . [and] the contract for services arises out

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[339] For example, corn "rents" were cited in An Inquiry into the Nature and Causes of the Wealth of Nations, Smith, Adam, 1776, at cp. 5, available at: http://www.gutenberg.org/files/3300/3300-h/3300-h.htm. This eBook is for the use of anyone anywhere at no cost and with almost no restrictions whatsoever. You may copy it, give it away, or re-use it under the terms of the Project Gutenberg License included with this eBook or online at www.gutenberg.org.

[340] 42 FR 14832, 14833, Mar. 16, 1977.

[341] 76 FR at 71689.

of the production, manufacturing, processing, use, or transportation of the commodity underlying the [commodity derivative contract], which may not exceed one year for agricultural" commodity derivative contracts; such positions would be subject to the five-day rule. That provision also made such positions subject to a provision for cross-commodity hedging, namely that, "The fluctuations in the value of the position in [commodity derivative contracts] are substantially related to the fluctuations in value of receipts or payments due or expected to be due under a contract for services."[342]

The Commission has reconsidered its proposed exemption in vacated § 151.5(a)(2)(vii) and now re-proposes an enumerated exemption that is largely the same, save for deleting the cross-commodity hedging provision in this enumerated exemption, as that provision is included under the cross-commodity hedging exemption, discussed below. Thus, the proposed exemption would recognize "sales or purchases" in commodity derivative contracts that are "offset by the anticipated change in value of receipts or payments due or expected to be due under an executed contract for services by the same person . . . [and] the contract for services arises out of the production, manufacturing, processing, use, or transportation of the commodity which may not exceed one year for agricultural" commodity derivative contracts; such positions would be subject to the five-day rule.

As the Commission previously noted and under this proposed exemption, "crop insurance providers and other agents that provide services in the physical marketing channel could qualify for a bona fide hedge of their contracts for services arising out of

[342] Vacated § 151.5(a)(2)(vii)(B).

the production of the commodity underlying a [commodity derivative contract]."[343] The Commission invites comment on all aspects of this new services exemption.

2) Cross-commodity hedges — paragraph (5)

The proposed cross-commodity hedging provision would apply to all enumerated hedges in paragraphs (3) and (4) of the definition of bona fide hedging position, as well as to pass-through swaps under paragraph (2).[344] The Commission has long recognized cross-commodity hedging, noting in 1977 that sales for future delivery of any product or byproduct which is offset by the ownership of fixed-price purchase of the source commodity would be covered by the general provisions for cross-commodity hedging in § 1.3(z)(2).[345]

Under the proposed enumerated exemption, cross-commodity hedging would be conditioned on: (i) the fluctuations in value of the position in the commodity derivative contract (or the commodity underlying the commodity derivative contract) are substantially related to the fluctuations in value of the actual or anticipated cash position or pass-through swap (the "substantially related" test); and (ii) the five-day rule being

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[343] 76 FR at 71654.

[344] Compare with vacated § 151.5(a)(2)(viii), which provided for cross-commodity hedges in enumerated positions but not for pass-through swaps.

[345] 42 FR 14832, 14834, Mar. 16, 1977. The Commission noted its belief that there is little commercial need to maintain cross-hedge positions during the last five trading days of any expiring contract. It believed the five-day restriction was necessary to guarantee the integrity of the markets. The Commission considered there was little commercial utility of such positions during the last five days of trading to offset anticipated production, which at that time was limited to agricultural commodities. The Commission considered its responsibility for orderly markets and concluded not to propose an enumerated exemption in the last five days of trading for anticipatory production. See also 7 U.S.C 6a(3)(B) (1970). That statutory definition of bona fide hedging included "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." Id.

applied to positions in any physical-delivery commodity derivative contract.[346] As discussed above, the five-day rule would not restrict positions in cash-settled contracts, but would restrict only positions in physical-delivery commodity derivative contracts. Thus, the Commission is protecting the integrity of the delivery process in the physical-delivery contract. Further, as noted above, few traders typically hold a position in excess of the position limits during the last few days of the spot month. Hence, a cross-commodity hedger who held a position deep into the spot month in excess of the spot position limit likely would be large relative to all traders. Such large positions may interfere with convergence of the commodity derivative contract with the cash market price, since the supply and demand expectations for cross-commodity hedgers may differ from those of persons hedging price risks of the commodity underlying the physical-delivery derivative.

Substantially related test. The Commission is proposing guidance on the meaning of the substantially related test. The Commission is proposing a non-exclusive safe harbor for cross-commodity hedges.[347] The safe harbor would have two factors: (i) qualitative; and (ii) quantitative.

Qualitative factor: As a first factor in assessing whether a cross-commodity hedge is bona fide, the target commodity should have a reasonable commercial relationship to the commodity underlying the commodity derivative contract. For example, there is a reasonable commercial relationship between grain sorghum

[346] Compare with current § 1.3(z)(2)(iv), which requires compliance with the substantially related test and with the five-day rule, and does not provide an exception to the five-day rule for cash-settled contracts.
[347] The Commission understands that cross-commodity hedges in physical commodities are not generally recognized by accountants as eligible for hedge accounting treatment.

(commonly called milo), used as a food grain for humans or as animal feedstock, with corn underlying a commodity derivative contract.[348]

In contrast, there does not appear to be a reasonable commercial relationship between a physical commodity and a stock price index; while long-term price series of such commodities may be statistically related by either inflation or measures of economic activity, such disparate commodities do not appear to have the requisite commercial relationship. Such correlation appears for this purpose to be spurious.

Quantitative factor: The target commodity should also be offset by a position in a commodity derivative contract that provides a reasonable quantitative correlation and in light of available liquid commodity derivative contracts. The Commission will presume an appropriate quantitative relationship exists when the correlation (R), between first differences or returns in daily spot price series for the target commodity and the price series for the commodity underlying the derivative contract (or the price series for the derivative contract used to offset risk), is at least 0.80 for a time period of at least 36 months.[349] When less granular price series than daily are used, R typically will be higher. Thus, price series data of at least daily frequency should be used, if available.

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[348] See, e.g., "The Alternative Field Crops Manual," University of Minnesota, November 1989, available at http://www.hort.purdue.edu/newcrop/afcm/sorghum.html.

[349] By way of comparison, accounting practice may look to goodness of fit (R^2) to be at least 0.80. The proposed correlation (R) of 0.80 corresponds to an R^2 of 0.64, substantially less than accounting practice. Further, accounting practice may look to the coefficient (hedge ratio) from a regression analysis to be in the range of negative 0.80 to 1.25. The Commission notes that the size of this coefficient is dependent upon the unit of trading for the hedging instrument and the unit of trading for the target of the hedge. To the extent both may be expressed in similar terms, the coefficient may fall within the range suggested by accounting practice. However, given standardized hedging instruments such as futures are fixed in terms of a particular price quote for a commodity (such as in dollars per bushel) and the target of a cross-commodity hedge may not have units fixed in the same terms (such as in dollars per hundred weight), the hedge ratio will depend on a fairly arbitrary choice of units to express the price series of the target of the hedge. Thus, the Commission is not proposing any particular safe harbor or requirement for a hedge ratio.

The Commission will presume that positions in a commodity derivative contract that does not meet the safe harbor are not bona fide cross-commodity hedging positions. However, a person may rebut this presumption upon presentation of facts and circumstances demonstrating a reasonable relationship between the spot price series for the commodity to be hedged and either the spot price series for the commodity underlying the commodity derivative contract or the price series for the commodity derivative contract to be used for hedging. A person should consider whether there is an actively traded commodity derivative contract that would meet the safe harbor, in light of liquidity considerations. A person may seek interpretative relief under § 140.99 for recognition of such a position as a bona fide hedging position.

Generally, a regression or time series analysis of prices should be performed to determine an appropriate hedge ratio.[350] Many price series are non-stationary because the prices increase with time and, thus, do not revert to a mean (i.e., stationary) price level. A regression on non-stationary data can give rise to spurious values for the "goodness of fit" and other statistics.[351] Thus, a quantitative analysis should be performed using first differences or returns (percentage price changes) so as to render the time series stationary.[352] However, the Commission is not proposing to condition the substantially related test on any particular hedge ratio methodology.

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[350] The Commission notes this safe harbor is intentionally written in general terms. Appropriate hedge ratios may be determined using an appropriate model, including but not limited to ordinary lease squares (OLS), autoregressive conditional heteroscedasticity (ARCH), generalized autoregressive conditional heteroscedasticity (GARCH), or an error-correction model (ECM).

[351] "Goodness of fit" is defined as: "A general term describing the extent to which an econometrically estimated equation fits the data. There are various ways of summarizing this concept, including the coefficient of determination and adjusted R^2." "The MIT Dictionary of Modern Economics," 4th Ed. (1996).

[352] See, e.g., "A Guide to Econometrics," 5th Ed., The MIT Press (2003), at p.319.

By way of example, the Commission believes that fluctuations in the value of electricity contracts typically will not be substantially related to fluctuations in value of natural gas. There may not be a substantial relation, for example, because the marginal pricing in a spot market may be driven by the price of something other than natural gas, such as nuclear, coal, transmission, outages, or water/hydroelectric power generation. Table 5 below shows illustrative simple correlations, both in terms of levels and returns, between spot electricity prices and natural gas (both spot Henry Hub prices and the nearby NYMEX Henry Hub Natural Gas futures prices, assuming a roll to the next deferred futures contract on the eleventh calendar day of each month). These correlations are much lower than the proposed safe harbor level of 0.80.

Table 5. Correlations — Spot Electricity Prices and Natural Gas (spot and futures) Prices January 2, 2009 to May 14, 2013

Price series:	Correlations using:	Henry Hub spot	Henry Hub futures
Houston electricity	Levels	0.1333	0.0630
	Returns	0.1264	0.0488
PJM electricity	Levels	0.4415	0.2724
	Returns	0.0987	0.0153
New England electricity	Levels	0.3450	0.2422
	Returns	0.1808	0.0121

Data sources: Henry Hub Gulf Coast Natural Gas Spot Price ($ per mmBTUs) and Natural Gas Futures Contracts ($ per mmBTU), source: US Energy Information

Administration, available at http://www.eia.gov/dnav/ng/ng_pri_fut_s1_d.htm; Wholesale Day Ahead Prices at Selected Hubs, Peak (5/16/2013), source: US Energy Information Administration, republished from the Intercontinental Exchange (ICE), available at http://www.eia.gov/electricity/wholesale/.

Alternatively, a generator of electricity that owns or leases a natural gas generator may qualify for an unfilled anticipated requirements bona fide hedge to meet a fixed price power commitment (sale of electricity). The position that is hedged is the quantity equivalent of natural gas through the generator to meet the contracted fixed price power commitment.[353] A natural gas hedge exemption can also be applied to operating characteristics of the plant and sources of revenue such as ancillary services.

3) Examples of bona fide hedging positions in Appendix B

The Commission is providing examples to illustrate enumerated bona fide hedging positions. The Commission invites comment on all aspects of the examples.

h. Non-enumerated hedging exemptions

The Commission proposes to replace the existing procedures for persons seeking non-enumerated hedging exemptions under current § 1.3(z)(3) and § 1.47 with proposed § 150.3(e), discussed further below, that would provide guidance for persons seeking non-enumerated hedging exemptions through filing of a petition under section 4a(a)(7) of the Act. As noted above, practically all non-enumerated hedging exemption requests were from persons seeking to offset the risk arising from swap books, which the Commission has addressed in the proposed pass-through swaps and pass-through swap

[353] A generator must also be able to satisfy any operating constraints, including minimum production runs.

offsets, and in the proposal to net positions in futures and swap reference contracts for purposes of single-month and all-months-combined position limits.

The Commission requests comment on industry practices involving the hedging of risks of cash market activities in a physical commodity that are not specifically enumerated in in paragraphs (3), (4), and (5) of the proposed definition of bona fide hedging position, the extent to which such hedging practices reflect industry standards or best practices and the particular sources of changes in value that such hedging positions offset.

Under the proposal for hedges of physical commodities, additional enumerated hedges could only be added to the proposed definition of bona fide hedging position by way of notice and comment rulemaking. Should the Commission adopt, as an alternative, an administrative procedure that would allow the Commission to add additional enumerated bona fide hedges without requiring notice and comment rulemaking? If so, what procedures should be used? Is current § 1.47 an appropriate process? And what standards, in addition to the statutory standards of CEA section 4a(c)(2), should be applicable to any such administrative procedure? The Commission is particularly concerned about the absence of standards in current § 1.47. If the Commission were to adopt such an administrative procedure, how should the Commission address the factors in CEA section 4a(a)(3)(B) in such an administrative procedure?

<u>No Proposal of Unfilled Storage Capacity as an Anticipated Merchandizing Hedge.</u> The Commission is not re-proposing a hedge for unfilled storage capacity that was in vacated § 151.5(a)(2)(v). That exemption would have permitted a person to establish as a bona fide hedge offsetting sales and purchases of commodity derivative

contracts that did not exceed in quantity the amount of the same cash commodity that was anticipated to be merchandized. That exemption was limited to the current or anticipated amount of unfilled storage capacity that the person owned or leased.

The Commission previously noted it had not recognized anticipated merchandising transactions as bona fide hedges due to its historic view that merchandizing transactions generally fail to meet the economically appropriate test.[354] The Commission explained, "A merchant may anticipate that it will purchase and sell a certain amount of a commodity, but has not acquired any inventory or entered into fixed-price purchase or sales contracts. Although the merchant may anticipate such activity, the price risk from merchandising activity is yet to be assumed and therefore a transaction in [commodity derivative contracts] could not reduce this yet-to-be-assumed risk." In response to comments, the Commission opined that, "in some circumstances, such as when a market participant owns or leases an asset in the form of storage capacity, the market participant could establish market positions to reduce the risk associated with returns anticipated from owning or leasing that capacity. In these narrow circumstances, the transaction in question may meet the statutory definition of a bona fide hedging transaction."

With the benefit of further review, the Commission now sees a strong basis to doubt that such a position generally will meet the economically appropriate test. This is because the value fluctuations in a calendar month spread in a commodity derivative contract will likely have at best a low correlation with value fluctuations in expected returns (e.g., rents) on unfilled storage capacity. There are at least two factors that

[354] 76 FR at 71646.

contribute to the size of a calendar month spread.[355] One factor is the cost of carry, comprised of the anticipated storage cost plus the interest paid to finance purchase of the physical commodity over the time period of the calendar month spread.[356] A second factor, and likely the factor that most contributes to value fluctuations in the calendar month spread, is the difference in the anticipated supply and demand of a commodity on the different dates of the calendar month spread. In this context, a calendar month spread position would likely increase, rather than decrease, risk in the operation of a commercial enterprise. Accordingly, for these reasons, the Commission is not re-proposing to recognize a bona fide hedging position based on an unfilled storage bin and any of a number of commodities that a merchant might store in such bin.

For example, the Commission recognizes there is commercial risk in operating off-farm storage, including the risk that total grain production may not be sufficient to ensure capacity utilization of such storage. Business costs of providing off-farm storage include the fixed cost of the storage facility and the variable costs for labor and fuel, in addition to other costs such as insurance. However, as the Commission noted above, based on its experience, the value fluctuations in a calendar month spread in a commodity derivative contract will likely have at best a low correlation with value fluctuations in expected returns (e.g., rents) on unfilled storage capacity. Therefore, the Commission requests comment on what positions in commodity derivative contracts, if any, would offset the value changes in the commercial risks (e.g., changes in anticipated rental

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[355] A calendar month spread generally means the purchase of one delivery month of a given futures contract and simultaneous sale of a different delivery month of the same futures contract. See CFTC Glossary, available at http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/index.htm.

[356] For a brief discussion of cost of carry, see, e.g., "Options, Futures, and Other Derivatives," 3rd Ed., Hull, (1997) at p. 67.

income or changes in other revenue streams) arising from a commodity storage business. And for those positions that would offset value changes in the commercial risks, what data should the Commission obtain to verify such claims? By way of comparison, the Commission has recognized unsold anticipated production and unfilled anticipated requirements for processing, manufacturing or feeding, as the basis of a bona fide hedging position.[357] The Commission has required persons seeking to claim such production or requirements exemptions to file statements showing historical production or usage and anticipated production or usage.[358]

The Commission invites commenters to provide specific, empirical analysis and data that would demonstrate how particular types of transactions could reduce the value at risk of unfilled storage space that could support such an exemption.

i. Summary of disposition of Working Group petition requests

As noted above, the Working Group made ten requests for exemptions under vacated part 151.[359] The Commission summarizes and addresses in a brief statement each request, below.

Request One. Unfixed Price Transactions Involving a Non-Referenced Contract: In a hedge of an unfixed price purchase and unfixed price sale of a physical commodity in which one leg of the hedge is a referenced contract and the other leg is a non-referenced contract, the Working Group requests that the referenced contract leg of the hedge be treated as a bona fide hedging position.

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[357] See current § 1.3(z)(2)(i)(B) and (C).

[358] See current § 1.48.

[359] The Working Group Petition is available at http://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/wgbfhpetition012012.pdf.

The proposed definition of bona fide hedging position would permit Request One under proposed paragraphs (4)(ii)(B) and (5), discussed above.

Request Two. Offsetting Unfixed Price Transactions Hedged with Derivatives in the Same Calendar Month: The Working Group requests that hedges of an unfixed price purchase and an unfixed price sale of a physical commodity in which the separate legs of the hedge are in the same calendar month, but which do not offset each other, because they are in different contracts or for any other reason, be treated as bona fide hedging positions.

The proposed definition of bona fide hedging position would permit Request Two under proposed paragraphs (4)(ii)(B) and (5), discussed above.

Request Three. Unpriced Physical Purchase or Sale Commitments: The Working Group requests that referenced contracts used to lock in a price differential where one leg of the underlying transaction is an unpriced commitment to buy or sell a physical energy commodity, and the offsetting sale or purchase has not been completed, be treated as bona fide hedging transactions or positions.

This request would not be permitted under the proposed definition of bona fide hedging position. The transaction described in Request Three concerns a commercial entity that has entered into either an unfixed-price sale or an unfixed-price purchase, but has not entered into an offsetting purchase or sale contract. This differs from the proposed enumerated bona fide hedge exemption provided in paragraph (4)(ii) because both sides of the cash transactions have not been contracted.

Locking in the spread for the same commodity between two markets is prudent risk management when a commercial trader has a contractual commitment both to buy

and sell the physical commodity at unfixed prices in the same two markets. A commercial merchant may expect to match an unfixed-price purchase with an unfixed-price sale, regardless of which came first, and at that point, will qualify for a hedge exemption for the basis risk, under paragraphs (4)(ii) and (5), as discussed in Requests One and Two, above.

However, a trader has not established a definite exposure to a value change when that trader has established only an unfixed price purchase or sales contract. This cash position fails the change in value requirement. Considering the anticipated merchandizing transaction, a merchant may assert her intention, but merchandizing intentions alone are not sufficient to recognize a price risk (that is, the yet-to-be established pair of unfixed-price cash purchase and sales contracts). The Commission is concerned that exempting such a yet-to-be established cash position would make it difficult or impossible for the Commission to distinguish hedging from speculation. For example, a trader could maintain a derivatives position, exempt from position limits, until that trader enters into a subsequent cash market transaction that results in a book-out of the first unfixed-price cash market transaction. The trader could assert that changed conditions resulted in a change in intentions. Since market prices are continually changing to reflect new information and, thus, changing conditions, the Commission believes an exemption standard based on merchandizing intentions alone would be no standard at all.

The Commission recognizes there can be a gradation of probabilities that an anticipated transaction will occur. However, the example above offers no context in which to evaluate the nature or probability of an anticipated merchandising transaction,

and such context is essential to determining the nature of any price risk that has been realized and could support the existence of a bona fide hedge. The Commission notes that in such cases, the only way to evaluate the nature of any price risk would be for the Commission to be provided with particulars of the transaction. This can be done, under the current proposal, either by requesting a staff interpretive letter under §140.99 or seeking CEA section 4a(a)(7) exemptive relief. Furthermore, in instances where an entity can establish that the nature of their commercial operation is such that they have committed physical or financial resources towards the anticipated transaction, they should consider whether they can avail themselves of the exemption for unsold anticipated production or unfilled anticipated requirements exemptions.

Request Four. Binding, Irrevocable Bids or Offers: The Working Group requests that referenced contracts used to hedge exposure to market price volatility associated with binding and irrevocable fixed-price bids or offers be treated as bona fide hedging positions.

The contemplated transactions are not consistent with the enumerated hedges in proposed paragraphs (3)(i), as a hedge of a purchase contract, or (3)(ii), as a hedge of a sales contract, because the cash transaction is tentative and, therefore, neither a sale nor a purchase agreement.

In the Commission's view, a binding bid or offer by itself is too tenuous to serve as the basis for an exemption from speculative position limits, since it is an uncompleted merchandising transaction that, historically, has not been recognized as the basis for a bona fide hedging transaction under § 1.3(z)(2). Any related derivative would cover a conditional price risk for a bid or offer that would depend on that bid or offer being

accepted and, therefore, would not be economically appropriate to the reduction of risk. The commercial entity submitting a binding, fixed-price bid or offer is essentially subject to a contingent price risk.[360] The Commission also understands that some commercial entities submit bids or offers merely to obtain information about the request for proposal, without an intention of submitting a quote that is likely to be accepted.

Moreover, the Working Group's suggestion that the Commission condition its relief on a good-faith showing and immediate reclassification of the portion of the position not awarded against the bid or offer does not protect the market against the prospect that multiple participants may hold such a good-faith belief and may also hold a position in the same direction as the cover transaction. If the Commission were to grant relief with respect to such positions, then all persons who made good-faith bids or offers on a particular cash market solicitation would be eligible to enter into derivatives to cover their potential exposure, in addition to holding speculative positions on the same side of the market at the limit. Under such relief, such persons, in the aggregate, could hold derivatives as cover in an amount several times larger than the total amount to be awarded under the solicitation. Undue volatility could result when the winning bid is accepted and all the losing bidders simultaneously reduce their total positions to get below the speculative position limit level.

In contrast, under the Commission's proposed rules a commercial entity may cover the risk of a yet to be accepted bid or offer, provided its total position does not

[360] For example, if the entity submits a fixed-price bid, it runs the risk that either (a) it did not enter into a derivative hedge position that would cover an accepted bid, and before its bid was accepted, the cash market price decreased (so that it ends up paying an above-market price); or (b) it did enter into a derivatives position (a short position) that would cover an accepted bid, and before its bid was rejected, the derivative price increased so that the entity loses money when it lifts the short position. Either outcome would create a loss for the commercial entity.

exceed the Commission's speculative position limits. Thus, when such person's bid or offer is not accepted and that person's speculative position is appropriately limited, that person need not liquidate any of its position to come into compliance with limits. As discussed further below, the Commission proposes to set speculative limits at relatively high levels. Thus, a commercial entity is not likely to be constrained in covering bids or offers unless it also has a relatively large speculative position on the same side of the market.

Request Five. Timing of Hedging Physical Transactions: The Working Group requests that referenced contracts used to hedge a physical transaction that is subject to ongoing, good-faith negotiations, and that the hedging party reasonably expects to conclude, be treated as bona fide hedging transactions or positions.

As with Request Four, the contemplated transactions are not consistent with the enumerated hedges in proposed paragraphs (3)(i), as a hedge of a purchase contract, or (3)(ii), as a hedge of a sales contract, because the cash transaction is tentative (here, subject to negotiation) and, therefore, neither a sale nor a purchase agreement.

The Commission is concerned that a trader has not established a definite exposure to a value change when that trader has only entered into negotiations for a fixed-price purchase or sales contract. This tentative cash position thus fails the change in value requirement.

Further, a trader could assert that changed conditions resulted in a change in intentions and a failure to complete negotiations. Since market prices are continually changing to reflect new information and, thus, changing conditions, the Commission

believes an exemption standard based on merchandizing intentions alone (even if the merchant were engaged in good faith negotiations) would be no standard at all.

In the case where the anticipated merchandizing transaction is "naked," or not backed by any existing physical exposure, the Commission is not aware of a methodology for distinguishing naked merchandizing from speculation. In the case of a firm bid or offer not offset by existing physical exposure, an entity can, at the time the bid or offer is accepted, enter into a corresponding hedge transaction or, in the alternative, an entity can enter into a corresponding hedge transaction at the time the bid or offer is made provided the entity remains within the speculative position limits. The Commission invites comment on why hedging in this manner is insufficient to offset physical risks. The Commission asks that parties submitting comments detail the nature of their merchandizing operations and how they realize and account for physical risks related to anticipatory merchandizing transactions not offset by anticipated production or processing requirements. In particular, the Commission requests comment on appropriate measures to address the risks for contingent bids or offers. Under what circumstances should the Commission recognize contingent bids or offers as the basis of a bona fide hedging position? If the Commission were to do so, should only the expected value of the risk of such position be recognized? And what would be an appropriate methodology for distinguishing naked merchandizing from speculation? How should the Commission address the varying ex ante subjective probability of completion of such bids or offers? For example, is an ex post measure of completion, e.g., the ratio of completed transactions to bids or offers, an acceptable proxy to impute the probability of acceptance for purposes of determining an ex ante hedge ratio, regardless of the expected probability

of completion on a particular bid or offer? Should the Commission require a person, seeking to claim an exemption based on contingent bids or offers, keep complete records of all such cash market bids or offers? If so, what record format and specific data elements should be kept?

Request Six. Local Natural Gas Utility Hedging of Customer Requirements: The Working Group requests that long positions in referenced contracts purchased by a state-regulated public utility to hedge the anticipated natural gas requirements of its retail customers be treated as bona fide hedging transactions or positions.

The proposed definition of bona fide hedging position would permit Request Six under proposed paragraph (3)(iii)(B), discussed above.

Request Seven. Use of Physical-Delivery Referenced Contracts to Hedge Physical Transactions Using Calendar Month Average Pricing: The Working Group argues that referenced contracts used to hedge in connection with calendar month average ("CMA") pricing are not speculative in nature and should be exempt from speculative position limits. The Working Group requests that firms engaged in CMA-priced transactions involving physical-delivery referenced contracts be permitted to hold those positions through the spot month as bona fide hedging positions.

The discussion below summarizes and addresses the petitioner's scenarios under Request Seven and notes the proposed exemptions that would be applicable or the reasons for denial.

Summary of Scenario 1: Refinery hedging unfilled anticipatory requirements for crude oil on a calendar month average basis and cross-hedging the sale of anticipated processed distillate products[361]

The Working Group noted that a refinery may buy crude oil on a CMA basis. The petitioner describes a three-step program whereby a refinery might buy crude oil on a CMA basis and subsequently sell distillate products on a CMA basis. First, on each trading day over approximately a one month period prior to expiration of the nearby NYMEX light sweet crude oil (WTI) futures contract, the refinery purchases futures contracts in the nearby contract month and sells an equivalent amount of futures in the next two deferred contract months in that same futures contract. The resulting positions are calendar month spreads in WTI futures contracts that are acquired at an average price over the one-month period. Second, following the establishment of the spread positions in WTI futures contracts, the refinery engages in exchange of futures for physical commodity (EFP) transactions, obtaining a short nearby WTI futures position in exchange for entering into cash market contracts for purchase of crude oil at a fixed price over the following calendar month.[362] These nearby short WTI futures positions offset the nearby long WTI futures positions of the calendar month spread. Alternatively, the refinery stands for delivery on the nearby long WTI futures positions. As a result, the

[361] The petitioner separately requested relief for a seller of crude oil on a CMA basis that had contracted to deliver crude oil ratably to a refiner during a month at the daily average spot price. That is, the seller entered into an unfixed price forward sales contract to the refiner. Such a transaction would be covered by the existing bona fide hedging rules. Such an unfixed price sales contract would become partially fixed as each day in the month locked in the daily spot price that would be used to fix the price of deliveries in the forward delivery period. Thus, to the extent the price of the forward contract was partially fixed, a seller could use long positions in commodity derivative contracts to offset the risk of the partially-fixed-price sales contract under the provisions of proposed paragraph (3)(i).

[362] Under NYMEX rules regarding EFP transactions in WTI futures, the buyer and seller of futures must be the seller and buyer of an approximately equivalent quantity of the physical product underlying the futures. See NYMEX rule 200.20 (available at http://www.cmegroup.com/rulebook/NYMEX/2/200.pdf), and NYMEX rule 538 (available at http://www.cmegroup.com/rulebook/NYMEX/1/5.pdf).

refinery holds only short deferred month WTI futures positions. Third, as the refinery takes deliveries of crude oil over the following calendar month on the cash market contracts (or alternatively under the physical delivery provisions of the futures contracts), the refinery processes the crude oil then sells the distillate products on the spot market. As the sales of distillate products occur, the refinery buys back the short WTI futures positions in the next two contract months.

The contemplated long positions are consistent with proposed paragraph (3)(iii) to the extent a refinery does not establish a long position in excess of that refinery's unfilled anticipated requirements for crude oil for the next two months. Further, in the case of a refinery, the Commission notes that, unless the refinery has fixed price sales[363] or offsetting short positions of the expected processed cash products, such contemplated long positions in WTI futures alone may not be economically appropriate to the reduction of risk in the conduct and management of a commercial enterprise; hence, the Commission also views the short positions in WTI futures to be an integral component of the contemplated calendar spreads.

Regarding the short positions, the Commission considers the economic consequences of the positions over two time periods: (1) the period of time the refinery holds a calendar spread position (long nearby and short deferred WTI contract months); and (2) the subsequent period of time when the refinery holds only a short position in

[363] A refinery with fixed price sales contracts may, as appropriate, enter into a long position in commodity derivative contracts as a bona fide hedging position or cross-commodity hedging position under proposed paragraphs (3)(ii) and (5).

WTI futures[364] and has a fixed price purchase contract on which it receives crude oil that it processes into distillate products.

Regarding the first time period, when considered as a whole with the long positions covering the unfilled anticipated requirements, the refinery's short positions would be risk reducing transactions, and therefore would qualify under proposed paragraphs (4)(i) and (5), so long as the long futures positions (meeting the unfilled anticipated requirements of paragraph (3)(iii)) fix the input price and the short futures positions fix a significant portion of the price of the expected output of petroleum distillate products that are not yet sold at a fixed price. The refinery's short position in referenced contracts would be an economically appropriate cross-commodity hedge, as contemplated by paragraph (5), to the extent the fluctuations in value of the anticipated processed cash commodities (that is, the petroleum distillates) are substantially related to fluctuations in value of the referenced contracts in crude oil.[365]

During the second time period, the refinery, for example, contracts for the purchase of crude oil at a fixed price (as a result of the EFP transaction) or subsequently holds crude oil in inventory (e.g., through taking delivery on the WTI futures contracts). Thus, the refinery in the second time period initially holds a bona fide hedging position under paragraph (3)(A). Once the crude oil is processed, the refinery also may continue

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[364] The refinery's long position in WTI futures would be liquidated as a result of the EFP transaction that established the fixed price purchase contract.

[365] Regarding the first time period, there is another enumerated bona fide hedging exemption involving offsetting commodity derivative contracts. Offsetting sales and purchases of commodity derivative contracts would be recognized as bona fide hedging positions to reduce the risk of unfixed price purchase and sales contracts of the cash commodity (paragraph (4)(ii)). This provision does not recognize positions as bona fide hedges under the five-day rule (i.e., during the lesser of the last five days of trading or the spot month for physical-delivery commodity derivative contracts). The refinery short positions are not similar to positions established to offset the risk of unfixed price sales and purchases, in that the refinery has not entered into open price purchase and sales contracts.

to hold short crude oil futures contracts as a cross-hedge of distillate products under paragraph (5). Proposed paragraph (5) permits a cross-commodity hedge when the fluctuations in value of the position in the commodity derivative contract are substantially related to the fluctuations in value of the actual or anticipated cash position. In this example, the aggregate price fluctuations of all of the distillate products of crude oil are substantially related to the price fluctuations of crude oil, with such prices expected to differ by refining costs and an expected processing margin. Thus, the refinery in the second time period holds a short futures position that is a bona fide inventory hedge or a bona fide cross-commodity hedge permitted under existing and proposed rules.

Summary of Scenario 2: Merchant short hedge of CMA price purchase of crude oil from producer, and long position to cover anticipated re-sale of crude oil at CMA.

In its January 20, 2012, petition, the Working Group gives the example of a producer that sells oil at the price at which it was valued (basis WTI futures) on each day it was extracted from the earth. The buyer is an aggregator that pays each producer for crude oil on a CMA basis for the production of the prior month. The aggregator seeks to ensure the CMA selling price for the oil purchased from the producers.

The aggregator sells the nearby WTI futures each trading day over a one month period and buys an equivalent quantity of WTI futures contracts in the subsequent two deferred WTI contract months.

Subsequently, the aggregator intends, in an EFP transaction, to exchange long futures in the nearby contract month, for a sales contract to be delivered ratably over the delivery period of that nearby contract month. (The long futures from the EFP transaction would offset the short WTI futures in the nearby contract month.) The

aggregator would sell the long futures contracts each day as oil is delivered ratably during the month. By ratably selling the long futures as the physical barrels are delivered, the aggregator effectively realizes the price of the prompt barrel on that trading day.

Alternatively, in its April 17, 2012 supplement, the Working Group argues that it should be sufficient that an aggregator wants to lock in CMA pricing for a sales commitment by entering into the spread position described above, regardless of the facts relating to the purchase side of the transaction.

Because the aggregator is selling futures daily as the price on the aggregator's contractual purchase commitment is being fixed for each day's production, the aggregator builds a short futures position to offset the crude oil it will eventually purchase from the producer under the CMA cash contract at a price that is partially fixed each day the short position is acquired. Once the aggregator is committed at a fixed price to take delivery of the oil, the aggregator holds a bona fide hedging position under paragraph (3)(A), which continues to be a bona fide hedging position under that rule after the aggregator takes delivery of the oil.

The Commission has not recognized as bona fide hedging a long futures position (as a synthetic sales price for the same commodity), when a person holds either inventory or a fixed-price purchase contract, the price risk of which has been offset using a short futures position. From the scenario and alternative presented, it is not clear that there is a price risk that is being reduced. Rather, the aggregator appears to seek to establish a sales price, without a corresponding uncovered price risk in either inventory or fixed-price sales or fixed-price purchase contracts. Thus, the transactions do not satisfy the requirements of the proposed definition of bona fide hedging position.

In considering the petition, the Commission reviewed its historical policy position with respect to bona fide hedges in light of position information regarding physical-delivery energy futures contracts. The Commission reviewed three years of confidential large trader data in cash-settled and physical-delivery energy contracts.[366] The review covered actual positions held in the physical-delivery energy futures markets during the three-day spot period, among all traders (including those who had received hedge exemptions from their DCM). It showed that, historically, there have been relatively few positions held in excess (and those few not greatly in excess) of the spot month limits. Accordingly, the Commission does not propose to grant the Working Group's requests regarding Scenario 2.

Nonetheless, the Commission notes that a person desiring to establish a synthetic sales price may hold a position subject to the spot month limit, but cautions that such person should trade so as not to disrupt the settlement price of the physical-delivery contract.

Working Group Petition Requests Eight, Nine, and Ten

Request Eight. Holding a Hedge Using a Physical-Delivery Contract into the Spot Month; Generally: The Working Group requests that firms that use physical-delivery referenced contracts (in commodities other than metals or agriculture) as bona

[366] The Commission typically does not publish "general statistical information" as authorized by CEA section 8(a)(1) regarding large trader positions in the expiring physical-delivery energy futures contracts because of concerns that such data may reveal information about the amount of market power a person may need to "mark the close" or otherwise manipulate the price of an expiring contract. Marking the close refers to, among other things, the practice of acquiring a substantial position leading up to the closing period of trading in a futures contract, followed by offsetting the position before the end of the close of trading, in an attempt to manipulate prices in the closing period. The Commission gathers large trader position reports on reportable traders in futures under part 17 of the Commission's rules. That data generally is confidential pursuant to section 8 of the Act. The Commission does, however, publish summary statistics for all-months-combined in its Commitments of Traders Report, available at http://www.cftc.gov/MarketReports/CommitmentsofTraders/index.htm.

fide hedging transactions or positions be permitted to hold these hedges into the spot month.

Request Nine. Holding a Cross-Commodity Hedge Using a Physical Delivery Contract into the Spot Month: The Working Group requests that firms that use physical-delivery referenced contracts as a cross-commodity hedge be permitted to hold these hedges into the spot month.

Request Ten. Holding a Cross-Commodity Hedge Using a Physical-Delivery Contract to Meet Unfilled Anticipated Requirements:[367] The Working Group argued that the Commission should "reinstate" § 1.3(z)(2)(ii)(C)[368] to permit firms to hold cross-commodity hedges involving physical-delivery referenced contracts into the spot month in order to meet their unfilled anticipated requirements.

The proposed definition of bona fide hedging position would permit Request Eight under proposed paragraphs (3)(C), discussed above, for hedges of unfilled anticipated requirements.[369]

However, the proposed definition does not recognize the other requests as bona fide hedging positions. As discussed above, the Commission continues to believe that, as a physical-delivery commodity derivative contract approaches expiration, it is necessary to protect orderly trading and the integrity of the markets. A person holding a large

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[367] Request Ten is similar to Request Eight, which also deals with unfilled anticipated requirements. However, Request Eight deals with requirements for the same commodity, whereas Request Ten involves cross-hedging in a different commodity.

[368] Prior to the court's order vacating part 151, § 1.3(z) was amended to in November 2011 to apply only to excluded (i.e., financial, not physical) commodities. Therefore, by requesting that this particular section of § 1.3(z) be "reinstated," petitioner is asking that it be applied once again to physical delivery (exempt and agricultural) commodities. However, § 1.3(z)(2)(iv) has never permitted a cross-commodity hedge under § 1.3(z)(2)(ii)(C) to be held into the five last trading days.

[369] The CME Petition also requested that the Commission recognize as bona fide hedges positions held into the five last trading days in physical-delivery referenced contracts that reduce the risk of two months unfilled anticipated requirements in the same cash commodity, as provided in § 1.3(z)(2)(ii)(C).

physical-delivery futures position who has no intention to make or take delivery may cause an unwarranted price fluctuation by demanding to liquidate such position deep into the delivery period in a physical-delivery agricultural contract or a metal futures contract or during the three-day spot period in a physical-delivery energy futures contract. Further, as noted above, a review of large trader positions in physical-delivery energy futures contracts does not show a current practice of traders holding large positions in the spot period of the physical-delivery energy referenced contracts relative to the exchange spot month limits.

The Commission invites comments on all aspects of the Working Group's petition and the Commission review.

2. Section 150.2 — Position limits

i. Current § 150.2

The Commission currently sets and enforces speculative position limits with respect to certain enumerated agricultural products.[370] Current § 150.2 provides in its entirety that "[n]o person may hold or control positions, separately or in combination, net long or net short, for the purchase or sale of a commodity for future delivery or, on a futures-equivalent basis, options thereon, in excess of [enumerated levels]."[371] As such, the speculative position limits set forth in current § 150.2 apply only to specific futures contracts traded on specific exchanges and, on a futures-equivalent basis, to specific

[370] The "enumerated" agricultural products refer to the list of commodities contained in the definition of "commodity" in CEA section 1a; 7 U.S.C. 1a. This list of agricultural contracts includes nine currently traded contracts: Corn (and Mini-Corn), Oats, Soybeans (and Mini-Soybeans), Wheat (and Mini-wheat), Soybean Oil, Soybean Meal, Hard Red Spring Wheat, Hard Winter Wheat, and Cotton No. 2. See 17 CFR 150.2. The position limits on these agricultural contracts are referred to as "legacy" limits because these contracts on agricultural commodities have been subject to federal positions limits for decades.

[371] 17 CFR 150.2. Footnote 1 to § 150.2 adds, "for purposes of compliance with these limits, positions in the regular sized and mini-sized contracts shall be aggregated." Id.

option contracts thereon.[372] "Futures-equivalent" is defined in current § 150.1(f) as "an option contract," and nothing else.[373] Accordingly, current § 150.2 establishes federal position limits only for specifically enumerated futures contracts on "legacy" agricultural commodities and options on those futures contracts.

In 2010, the Commission proposed to implement additional speculative position limits for futures and option contracts in certain energy commodities ("2010 Energy Proposal").[374] In the 2010 Energy Proposal, the Commission included a discussion of past and present position limits for certain agricultural contracts under part 150 stating that current § 150.2 applies only to specific agricultural futures and options contracts:

> [t]he current Federal speculative position limits of regulation 150.2 apply only to specific futures contracts [and] (on a futures-equivalent basis) specific option contracts. Historically, all trading volume in a specific contract tended to migrate to a single [futures] contract on a single exchange. Consequently, speculative position limits that applied to a single [futures] contract and options thereon effectively applied to a single market. The current speculative position limits of regulation 150.2 for certain agricultural contracts follow this approach.[375]

The Commission withdrew the 2010 Energy Proposal when the Dodd-Frank Act became law.[376]

The limited scope and applicability of the speculative position limits in current § 150.2, as well as in the 2010 Energy Proposal, are inconsistent with the congressional shift evidenced in the Dodd-Frank Act amendments to section 4a of the Act, upon which the Commission relies in this release. Amended CEA section 4a(a)(1) authorizes the Commission to extend position limits beyond futures and option contracts to swaps

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[372] See id.

[373] See 17 CFR 150.1(f).

[374] 75 FR 4142, Jan. 26, 2010.

[375] Id. at 4152–54.

[376] 75 FR 50950, Aug. 18, 2010.

traded on a DCM or SEF and swaps not traded on a DCM or SEF that perform or affect a significant price discovery function with respect to regulated entities ("SPDF swaps").[377] Further, new CEA section 4a(a)(5) requires that speculative position limits apply to swaps that are "economically equivalent"[378] to DCM futures and option contracts for agricultural and exempt commodities under new CEA section 4a(a)(2).[379] Similarly, new CEA section 4a(a)(6) requires the Commission to apply position limits on an aggregate basis to contracts based on the same underlying commodity across: (1) DCMs; (2) with respect to foreign boards of trade ("FBOTs"), contracts that are price-linked to a DCM or SEF contract and made available from within the United States via direct access; and (3) SPDF swaps.[380]

In 2011, the Commission proposed and, after comment, adopted rules to establish an expanded position limits regime pursuant to the mandate contained in the Dodd-Frank Act amendments to CEA section 4a.[381] However, in an Order dated September 28, 2012,

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[377] 7 U.S.C. 6a(a)(1).

[378] Section 4a(a)(5) of the Act requires the Commission to impose the same limits on "swaps" that are "economically equivalent" to futures and options contracts. The statute does not define the term. But the Commission construes it, consistent with the policy objectives of the Dodd-Frank amendments, to require the Commission to expeditiously impose limits on physical commodity swaps that are price-linked to futures contracts, or to satisfy other defined equivalence criteria. The Commission accordingly construes the term "economically equivalent" to require swaps to satisfy the definition of "referenced" contract in proposed § 150.1. It requires that a swap be, among other things, "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; or … 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…" Other similarities or differences that exist between futures and swaps are not material to the Commission's interpretation of economic equivalence under 7 U.S.C. 6a(a)(5).

[379] 7 U.S.C. 6a(a)(2), (5).

[380] 7 U.S.C. 6a(a)(6). The Commission refers to this requirement in section 4a(a)(6) of the Act as a requirement for position aggregation.

[381] The Commission instructed market participants to continue to comply with the existing position limit regime contained in part 150 and any applicable DCM position limits or accountability levels until the compliance date for the position limits rules in new part 151. After such date, part 150 would have been revoked and compliance with part 151 would have been required. 76 FR 71632.

the U.S. District Court for the District of Columbia vacated the 2011 Position Limits Rulemaking, with the exception of the revised position limit levels in amended § 150.2.[382] Therefore, part 150 continues to apply, as amended, as if part 151 had not been finally adopted by the Commission.[383]

Vacated part 151 would have established federal position limits and limit formulas for 28 physical commodity futures and option contracts, or "Core Referenced Futures Contracts," and would have applied these limits to all derivatives that are directly or indirectly linked to the price of a Core Referenced Futures Contract (collectively, "Referenced Contracts").[384] Therefore, the position limits in vacated part 151 would have applied across different trading venues to economically equivalent Referenced Contracts (as specifically defined in part 151) that are based on the same underlying commodity, a concept known as aggregate limits. Vacated § 151.1 defined "Referenced Contract" to mean:

> on a futures equivalent basis with respect to a particular Core Referenced Futures Contract, a Core Referenced Futures Contract listed in § 151.2, or a futures contract, options contract, swap or swaption, other than a basis contract or commodity index contract, that is: (1) 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; or (2) 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.[385]

In addition to establishing federal position limits for all Referenced Contracts, vacated part 151 would have, among other things, implemented a new statutory definition of bona

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[382] See 887 F. Supp. 2d 259 (D.D.C. 2012).

[383] The District Court's order vacated the final rule and the interim final rule promulgated in the 2011 Position Limits Rulemaking, with the exception of the rule's amendments to 17 CFR 150.2.

[384] 76 FR at 71629.

[385] Id. at 71685.

fide hedging transactions, revised the standards for position aggregation, and established position visibility reporting requirements.[386]

ii. Proposed § 150.2

Proposed § 150.2 would list spot month, single month, and all-months-combined position limits for 28 core referenced futures contracts. Consistent with section 4a(a)(5) of the Act, proposed § 150.2 would apply such position limits to all referenced contracts (as that term is defined in the proposed amendments to § 150.1)[387] including economically equivalent swaps.[388] Consistent with section 4a(a)(6) of the Act, proposed § 150.2 would apply position limits across all trading venues subject to the Commission's jurisdiction. Proposed § 150.2 would also specify Commission procedures for computing position limits levels.

a. Spot month limits.

Proposed § 150.2(a) provides that no person may hold or control positions in referenced contracts in the spot month, net long or net short, in excess of the level specified by the Commission for physical-delivery referenced contracts and, specified

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[386] See generally 76 FR 71626, Nov. 18, 2011.

[387] See discussion of proposed § 150.1 above.

[388] Section 4a(a)(5) of the Act requires the Commission to impose the same limits on "swaps" that are "economically equivalent" to futures and options contracts. The statute does not define the term. But the Commission construes it, consistent with the policy objectives of the Dodd-Frank amendments, to require the Commission to expeditiously impose limits on physical commodity swaps that are price-linked to futures contracts, or to satisfy other defined equivalence criteria. The Commission accordingly construes the term "economically equivalent" to require swaps to satisfy the definition of "referenced" contract in proposed § 150.1. It requires that a swap be, among other things, "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; or … 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 …." Other similarities or differences that exist between futures and swaps are not material to the Commission's interpretation of economic equivalence under 7 U.S.C. 6a(a)(5).

separately, for cash-settled referenced contracts.[389] Proposed § 150.2(a) requires that a trader's positions in the physical-delivery referenced contract and cash-settled referenced contract are to be calculated separately under the separate spot month position limits fixed by the Commission. Therefore, a trader may hold positions up to the spot month limit in the physical-delivery contracts, as well as positions up to the applicable spot month limit in cash-settled contracts (i.e., cash-settled futures and swaps), but a trader in the spot month may not net across physical-delivery and cash-settled contracts. Absent such a restriction in the spot month, a trader could stand for 100 percent of deliverable supply during the spot month by holding a large long position in the physical-delivery contract along with an offsetting short position in a cash-settled contract, which effectively would corner the market. The Commission will closely monitor the effects of its spot-month position limits.

b. Single-month and all-months-combined limits.

Proposed § 150.2(b) provides that no person may hold or control positions, net long or net short, in referenced contracts in a single-month or in all-months-combined in excess of the levels specified by the Commission. Proposed § 150.2(b) permits traders to net all positions in referenced contracts (regardless of whether such referenced contracts are physical-delivery or cash-settled) when calculating the trader's positions for purposes of the proposed single-month or all-months-combined position limits.[390]

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[389] The Commission proposes to adopt an amended definition of spot month in proposed § 150.1 (as discussed above), simplified from the spot-month definitions listed in vacated § 151.3. The term "spot month" does not refer to a month of time.

[390] The Commission would allow traders to net positions in physical-delivery and cash-settled contracts outside the spot month because the Commission is less concerned about corners and squeezes outside the spot month. Permitting such netting will significantly reduce the number of traders with positions over the levels of non-spot month limits. The Commission discusses how many traders historically held positions over the levels of non-spot month limits below.

The Commission also proposes to amend § 150.2 by deleting the potentially ambiguous phrase "separately or in combination." The Commission first proposed adding the phrase "separately or in combination" to § 150.2 in 1992.[391] While the text of current § 150.2 could be read in context to apply limits to futures or option positions, separately or in combination, the preamble to that rulemaking proposal stated otherwise, indicating the Commission was proposing a "unified approach" to limits on futures and options positions combined.[392] When considering at that time whether to extend the existing federal position limits on futures contracts also to option contracts (on a futures equivalent basis), the Commission explained that a unified futures and options level limit was "more appropriate for several reasons" than position limits on futures that are separate from position limits on options.[393] Further, the Commission noted in the 1992 preamble that "proposed Rule 150.2 provides that '[n]o person may hold or control net long or net short positions in excess of the stated limits."[394] Although the 1992 preamble stated the limit rule was to apply on a net basis to futures and options combined, the regulatory text could be read to suggest a different approach, i.e., applying to futures or options on both a separate basis and a combined basis. The phrase "separately or in combination" was not discussed in any subsequent Federal Register notice.[395]

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[391] See Revision of Federal Speculative Position Limits, Proposed Rules, 57 FR 12766, Apr. 13, 1992.

[392] Id. at 12768.

[393] Id. at 12769.

[394] Id. at 12770.

[395] Indeed, the Commission noted in 1993 when it adopted an interim final rule that "as proposed, speculative position limits for both futures and options thereon are being combined into a single limit." See interim final rule at 58 FR 17973, Apr. 7, 1993. The Commission noted it "proposed to unify speculative position limits for both futures and options thereon, reasoning that, because price movements in the two markets are highly related, the unified system more readily reflects the economic reality of a position in its totality. Moreover, unified speculative limits provide the trader with greater flexibility. Further, traders should find such a unified speculative position limit easier to use and to understand. Finally, as a

c. Selection of initial commodity derivative contracts in physical commodities.

As discussed above, the Commission interprets the CEA to mandate position limits for futures contracts in physical commodities other than excluded commodities (i.e., position limits are required for futures contracts in agricultural and exempt commodities).

The Commission is proposing a phased approach to implement the statutory mandate. The Commission is proposing in this release to establish speculative position limits on 28 core referenced futures contracts in physical commodities.[396] The Commission anticipates that it will, in subsequent releases, propose to expand the list of core referenced futures contracts in physical commodities. The Commission believes that a phased approach will (i) reduce the potential administrative burden by not immediately imposing position limits on all commodity derivative contracts in physical commodities at once, and (ii) facilitate adoption of monitoring policies, procedures and systems by

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consequence of the simpler structure, unified speculative position limits would be easier to administer, resulting in more accurate and timely market surveillance." Id. at 17974.

In discussing comments on the 1992 proposed rule, the Commission noted an objection by a DCM to the proposed unified futures and options limits, preferring the DCM's proposed separate futures and options limits. Id. at 17976. The Commission discussed views of other commenters regarding the proposed "unified limits." Id. at 17977. The Commission concluded that it would adopt the unified limits, noting it "will combine futures and option limits." The preamble also made clear the limits would not apply separately, noting further that "because such positions would be netted automatically under a unified speculative position limit, the Commission is removing and reserving § 150.3(a)(2) which exempts from Federal speculative position limits positions in option contracts which offset the futures positions." Id. at 17978-79.

[396] The 28 core referenced futures contracts are: Chicago Board of Trade Corn, Oats, Rough Rice, Soybeans, Soybean Meal, Soybean Oil and Wheat; Chicago Mercantile Exchange Feeder Cattle, Lean Hog, 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 (on September 6, 2013, CBOT and the Kansas City Board of Trade ("KCBT") requested that the Commission permit the transfer to CBOT, effective December 9, of all contracts listed on the KCBT, and all associated open interest); Minneapolis Grain Exchange Hard Red Spring Wheat; and New York Mercantile Exchange Palladium, Platinum, Light Sweet Crude Oil, NY Harbor ULSD, RBOB Gasoline and Henry Hub Natural Gas.

persons not currently subject to positions limits (such as traders in swaps that are not significant price discovery contracts).

The Commission proposes, initially, to establish position limits on these 28 core referenced futures contracts, and related swap and futures contracts, on the basis that such contracts (i) have high levels of open interest[397] and significant notional value of open interest[398] or (ii) serve as a reference price for a significant number of cash market transactions.[399] Thus, in the first phase, the Commission generally is proposing limits on those contracts that it believes are likely to play a larger role in interstate commerce than that played by other physical commodity derivative contracts.

In selecting the list of 28 core referenced futures contracts in proposed § 150.2(d), the Commission calculated the open interest and notional value of open interest for all futures, futures options, and significant price discovery contracts as of December 31, 2012 in all agricultural and exempt commodities. The Commission identified those commodities with the largest notional value of open interest and open interest for agricultural commodities, energy commodities, and metals commodities. The Commission then selected 16 agricultural commodities, 4 energy commodities, and 5 metals commodities. Once these commodities were selected, the Commission determined the most important futures contract, or contracts, within each commodity,

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[397] Open interest for this purpose is the sum of open contracts, as defined in § 1.3(t), in futures contracts and in futures option contracts converted to a futures-equivalent amount, as defined in § 150.1(f), and open swaps, as defined in § 20.1, on a future equivalent basis, as defined in § 20.1, where such swaps are significant price discovery contracts as determined by the Commission under § 36.3(d).

[398] Notional value of open interest for this purpose is open interest times the unit of trading for the relevant futures contract times the price of that futures contract.

[399] The Commission, in the vacated part 151 Rulemaking, selected for what was also intended as a first phase, the same 28 core referenced futures contracts on the same basis. 76 FR at 71629. As was noted when part 151 was adopted, the 28 core referenced futures contracts were selected on the basis that such contracts: (1) had high levels of open interest and significant notional value; or (2) served as a reference price for a significant number of cash market transactions. Id.

generally by selecting the physical-delivery contracts with the highest levels of open interest, and deemed these as the core referenced futures contracts for which position limits would be established in this release. As such, the Commission proposes in this release to set position limits in 19 core referenced futures contracts for agricultural commodities, 4 core referenced futures contracts for energy commodities, and 5 core referenced futures contracts for metals commodities. The Commission currently sets limits for 9 legacy agricultural contracts under part 150.[400]

In selecting the 16 agricultural commodities, the Commission used oats as its baseline since oats has the lowest notional value of open interest and the lowest open interest among the 9 legacy agricultural contracts. Hence, the Commission selected all agricultural commodities that have notional value of open interest and open interest that exceed that of oats.[401] The Commission has determined to defer consideration of speculative position limits on contracts in other agricultural commodities because the Commission must marshal its resources. The Commission anticipates that it will consider speculative position limits on contracts in other agricultural commodities in a subsequent rulemaking.

Table 6 below provides the notional value of open interest and open interest for agricultural contracts by type of commodity contract reported under the Commission's

[400] 17 CFR 150.2.

[401] While cheese has a notional value of open interest that is higher than oats, it has an open interest that is lower than that of oats (the open interest of the cheese contract was less than 10,000 contracts as of year-end 2012). Furthermore, all futures and options contracts in cheese are on the same DCM (which currently has a single month position limit set at 1,000 contracts) and had no Large Trader Reporting for physical commodity swaps as reported under part 20 during January 2013. The Commission intends to address cheese when it proposes, in subsequent releases, expansions to the list of referenced contracts in physical commodities.

reporting rules.[402] With respect to the type of commodity, it should be noted, for example, that "wheat" refers to the general type of physical commodity, and includes contracts listed on three different DCMs.

Table 6. Largest Agricultural Commodities Ranked by Notional Value of Open Interest in Futures, Futures Options, and Significant Price Discovery Contracts, as of December 31, 2012

Type and Rank within Type by Notion Value of Open Interest	Commodity	Number of Contracts	Notional Value of Open Interest	Open Interest
Agricultural				
1	Soybeans	6	$54.07 billion	765,030
2	Corn	6	$51.54 billion	1,545,135
3	Wheat	10	$41.06 billion	767,006
4	Sugar	5	$39.06 billion	896,082
5	Live Cattle	2	$19.91 billion	394,385
6	Coffee	3	$13.89 billion	211,147
7	Soybean Oil	4	$11.01 billion	344,412
8	Soybean Meal	2	$10.46 billion	253,361
9	Cotton	3	$9.75 billion	234,367
10	Lean Hogs	1	$9.68 billion	280,451
11	Cocoa	1	$5.13 billion	218,224
12	Feeder Cattle	1	$2.64 billion	34,816
13	Milk	3	$1.45 billion	40,690
14	Frozen Orange Juice	1	$609 million	29,652
15	Rice	1	$445 million	14,783
16	Cheese	2	$282 million	8,601
17	Oats	1	$187 million	10,755

For exempt commodity contracts, the Commission proposes to initially select the commodities in the energy and metals markets that have the largest open interest and notional value of interest. For metals, the Commission proposes to initially target the 5 largest commodities in terms of notional value of open interest, as listed in Table 7 below, and selected 1 core referenced futures contract for each of the 5 metals. In

[402] 17 CFR part 16. Commission staff computed notional values of open interest from data reported under § 16.01. Data reported under § 16.01 includes significant price discovery contracts in compliance with core principle VI for exempt commercial markets, app. B to part 36.

selecting these 5 core referenced futures contracts, the Commission would establish federal position limits on ninety-eight percent of the open interest in U.S. metals markets.

The next largest commodity in metals after palladium in terms of notional value is iron ore, which has open interest that is about one-quarter that of palladium.[403] Furthermore, there are less than 50 reportable traders[404] in iron ore, while in the 5 selected metals, each has more than 200 reportable traders. The Commission has determined to defer consideration of speculative position limits on contracts in iron ore and other metal commodities because the Commission must marshal its resources. The Commission anticipates that it will consider speculative position limits on contracts in iron ore and other metal commodities in a subsequent rulemaking.

Table 7. Largest Metals Commodities by Notional Value of Open Interest in Futures, Futures Options, and Significant Price Discovery Contracts, as of December 31, 2012

Type and Rank within Type by Notion Value of Open Interest	Commodity	Number of Contracts	Notional Value of Open Interest	Open Interest
Metals				
1	Gold	6	$100.41 billion	604,853
2	Silver	5	$27.77 billion	180,576
3	Copper	3	$13.28 billion	146,865
4	Platinum	1	$4.78 billion	61,467
5	Palladium	1	$2.08 billion	32,293

For energy commodities, the Commission similarly proposes to select the 4 largest commodities for this first phase of the expansion of speculative position limits and selected 1 core referenced futures contract in each of these 4 commodities. Each of these commodities has a notional value of open interest in excess of $40 billion.

[403] The open interest in iron ore futures, futures options, and significant price discovery contracts as of December 31, 2012, was 8,195 contracts and the notional value of open interest was $236.63 million.

[404] A reportable trader is a trader with a reportable position as defined in § 15.00(p).

The fifth largest commodity in energy is electricity, and the Commission has determined to defer consideration of speculative position limits on contracts in electricity and other energy commodities because the Commission must marshal its resources. The Commission anticipates that it will consider speculative position limits on contracts in electricity and other energy commodities in a subsequent rulemaking.

Table 8. Largest Energy Commodities by Notional Value of Open Interest in Futures, Futures Options, and Significant Price Discovery Contracts, as of December 31, 2012

Type and Rank within Type by Notion Value of Open Interest	Commodity	Number of Contracts	Notional Value of Open Interest	Open Interest
Energy				
1	Crude Oil	76	$516.42 billion	6,188,201
2	Heating Oil/Diesel	89	$470.69 billion	1,192,036
3	Natural Gas	216	$225.74 billion	21,335,777
4	Gasoline	54	$46.13 billion	402,369

d. Setting levels of spot-month limits.

Proposed § 150.2(e)(1) establishes the initial levels of speculative position limits for each referenced contract at the levels listed in appendix D to this part. These levels would become effective 60 days after publication in the Federal Register of a final rule adopted by the Commission. The Commission proposes to set the initial spot month position limit levels for referenced contracts at the existing DCM-set levels for the core referenced futures contracts because the Commission believes this approach is consistent with the regulatory objectives of the Dodd-Frank Act amendments to the CEA and many market participants are already used to these levels.[405]

[405] DCMs currently set spot-month position limits based on their own estimates of deliverable supply. Federal spot-month limits can, therefore, be implemented by the Commission relatively expeditiously.

As an alternative to the initial spot month limits in proposed appendix D to part 150, the Commission is considering setting the initial spot month limits based on estimated deliverable supplies submitted by the CME Group in correspondence dated July 1, 2013.[406] Under this alternative, the Commission would use the exchange's estimated deliverable supplies and apply the 25 percent formula to set the level of the spot month limits in a final rule if the Commission verifies the exchange's estimated deliverable supplies are reasonable. For purposes of setting initial spot month limits in a final rule, in the event the Commission is not able to verify an exchange's estimated deliverable supply for any commodity as reasonable, then the Commission may determine to adopt the initial spot month limits in proposed appendix D for such commodity, or such higher level based on the Commission's estimated deliverable supply for such commodity, but not greater than would result from the exchange's estimated deliverable supply. The Commission requests comment on whether the initial spot month limits should be based on the exchange's July 1, 2013, estimations of deliverable supplies, once verified. The spot month limits that would result from the CME's estimated deliverable supplies are show in Table 9 below.

Table 9. Alternative Proposed Initial Spot Month Limit Levels For Certain Core Referenced Futures Contracts (based on CME Group Estimates of Deliverable Supply submitted to the Commission on July 1, 2013)

Contract	Current Spot-Month Limit	Alternative Proposed Spot-Month Limit	CME Group Deliverable Supply Estimate	CME Group Deliverable Supply Estimate in

[406] Letter from Terrance A. Duffy, Executive Chairman and President, CME Group, to CFTC Chairman Gensler, Commissioner Chilton, Commissioner Sommers, Commissioner O'Malia, Commissioner Wetjen, and Division of Market Oversight Director Richard Shilts, dated July 1, 2013 (available at www.cftc.gov). The Commission notes the CME Group did not propose to set the level of spot month limits using the 25 percent formula in this letter.

		(25% of deliverable supply rounded up to the next 100 contracts)		contracts
Legacy Agricultural				
Chicago Board of Trade Corn (C)	600	1,000	19,590,000 bushels	3,918
Chicago Board of Trade Oats (O)	600	1,500	29,470,000 bushels	5,894
Chicago Board of Trade Soybeans (S)	600	1,200	23,900,000 bushels	4,780
Chicago Board of Trade Soybean Meal (SM)	720	4,400	1,753,047 tons	17,531
Chicago Board of Trade Soybean Oil (SO)	540	5,300	1,253,000 lbs.	20,883
Chicago Board of Trade Wheat (W)	600	3,700	73,790,000 bushels	14,757
Kansas City Board of Trade Hard Winter Wheat (KW)	600	4,100	81,710,000 bushels	16,342
Other Agricultural				
Chicago Board of Trade Rough Rice (RR)	600	1,800	14,100,000 cwt.	7,050
Chicago Mercantile Exchange Class III Milk (DA)	1500	5,300	4,170,000,000 lbs.	20,850
Energy				
New York Mercantile Exchange Henry Hub Natural Gas (NG)	1,000	3,900	154,200,000 mmBtu	15,420
New York Mercantile Exchange Light Sweet Crude Oil	3,000	12,100	48,100,000 barrels	48,100

(CL)				
New York Mercantile Exchange NY Harbor ULSD (HO)	1,000	5,500	20,000,000 barrels	22,000
New York Mercantile Exchange RBOB Gasoline (RB)	1,000	7,300	29,000,000 barrels	29,000
Metal				
Commodity Exchange, Inc. Copper (HG)	1,200	1,700	161,850,000 lbs.	6,474
Commodity Exchange, Inc. Gold (GC)	3,000	27,300	10,911,100 troy ounces	109,111
Commodity Exchange, Inc. Silver (SI)	1,500	5,700	113,375,000 troy ounces	22,675
New York Mercantile Exchange Palladium (PA)	650	1,500	578,900 troy ounces	5,789
New York Mercantile Exchange Platinum (PL)	500	800	152,150 troy ounces	3,043

The Commission is considering a further alternative to setting the spot month limit at a level based on 25 percent of estimated deliverable supply. This alternative would permit the Commission, in its discretion, both for setting an initial spot month limit and subsequent resets, to use the recommended level, if any, of the spot month limit as submitted by each DCM listing a CRFC (if lower than 25 percent of estimated deliverable supply). Under this alternative, the Commission would have discretion to set the level of any spot month limit to the DCM's recommended level, a level corresponding to 25 percent of estimated deliverable supply, or a level in proposed appendix D. The Commission requests comment on all aspects of this alternative.

Specifically, is the Commission's discretion in administering levels of spot month limits appropriately constrained by the choice, in its discretion, of the DCM's recommended level or the level corresponding to 25 percent of deliverable supply or a level in proposed appendix D?

Proposed § 150.2(e)(3) explains how the Commission will calculate spot month position limit levels. The Commission proposes to fix the levels of the spot-month limits for referenced contracts based on one-quarter of the estimated spot-month deliverable supply in the relevant core referenced futures contract, no less frequently than every two calendar years.[407] Under the proposal, each DCM listing a core referenced futures contract would be required to report to the Commission an estimate of spot-month deliverable supply, accompanied by a description of the methodology used to derive the estimate and any statistical data supporting the estimate.[408] Proposed § 150.2(e)(3) provides a cross-reference to appendix C to part 38 for guidance on how to estimate deliverable supply.[409] The Commission proposes to utilize the estimated spot-month deliverable supply provided by a DCM unless the Commission decides to rely on its own estimate of deliverable supply.

The Commission proposes to update spot-month limits every two years for each of the 28 referenced contracts, and to stagger the dates on which DCMs must submit estimates of deliverable supply. The Commission has re-evaluated data on the frequency

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[407] Federal spot month limits have historically been set at one-quarter of estimated deliverable supply. See, e.g., 64 FR 24038, 24041, May 5, 1999. Further, current guidance on complying with DCM core principle 5 calls for spot month levels to be set at "no greater than one-quarter of the estimated spot month deliverable supply . . . ." 17 CFR 150.5(c)(1).

[408] The timing for submission of such reports varies by commodity type – see proposed § 150.2(e)(ii)(A)–(D).

[409] See 17 CFR part 38, appendix C, at section (b)(1)(i).

with which DCMs historically have changed the levels of spot month limits in the 28 physical-delivery core referenced futures contracts. Given the low frequency of changes to DCM spot month limits, the Commission has reconsidered requiring annual updates for referenced contracts in agricultural commodities.[410] When compared with annual updates to the spot month position limits, biennial updates would reduce the burden on market participants in updating speculative position limit monitoring systems.[411]

The term "estimated deliverable supply" means the amount of a commodity that can reasonably be expected to be readily available to short traders to make delivery at the expiration of a futures contract.[412] The use of estimated deliverable supply to set spot-month limits is wholly consistent with DCM core principles 3 and 5.[413] Currently, in

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[410] In any event, core principle 5 in section 5(d)(5) of the Act imposes a continuing obligation on a DCM, where the DCM has set a position limit as necessary and appropriate, to ensure levels of position limits are set to reduce the potential threat of market manipulation or congestion (especially during the spot month). 7 U.S.C. 7(d)(5). Thus, a DCM appropriately would reduce the level of its exchange-set spot month limit if the level of deliverable supply declined significantly. Core principle 6 in section 5h(f)(6) of the Act imposes a similar obligation on a SEF that is a trading facility. 7 U.S.C. 7b-3(f)(6).

[411] Proposed § 150.2(e)(3) also provides the Commission with flexibility to reset spot month position limits more frequently than every two years, but the proposed rule would require DCMs to submit estimated deliverable supplies only every two years. This means, for example, that a DCM may with discretion provide the Commission with updated estimated deliverable supplies and petition the Commission to reset spot month limits more frequently than every two years. Similarly, proposed § 150.2(e)(4) provides the Commission with flexibility to change non-spot month position limits more frequently than every two years. This means, for example, that a DCM may petition the Commission to reset non-spot month position limits based on the most recent calendar-year's open interest.

[412] As part of its recently published guidance for complying with DCM core principle 3, the Commission provided guidance on how to calculate deliverable supplies in appendix C to part 38 (at paragraph (b)(1)(i)). 77 FR 36612, 36722, Jun. 19, 2012. Typically, deliverable supply reflects the quantity of the commodity that potentially could be made available for sale on a spot basis at current prices at the contract's delivery points. For a physical-delivery commodity contract, this estimate might represent product which is in storage at the delivery point(s) specified in the futures contract or can be moved economically into or through such points consistent with the delivery procedures set forth in the contract and which is available for sale on a spot basis within the marketing channels that normally are tributary to the delivery point(s).

[413] DCM core principle 3 specifies that a board of trade shall list only contracts that are not readily susceptible to manipulation. See CEA section 5(d)(3); 7 USC 7(d)(3). DCM core principle 5 (discussed in detail below) requires a DCM to establish position limits or position accountability provisions where necessary and appropriate "to reduce the threat of market manipulation or congestion, especially during the delivery month." CEA section 5(d)(5); 7 USC 7(d)(5). See also guidance and discussion of estimated

determining whether a physical-delivery contract complies with core principle 3, the Commission considers whether the specified contract terms and conditions may result in an estimated deliverable supply that is sufficient to ensure that the contract is not readily susceptible to price manipulation or distortion. The Commission has previously indicated that it would be an acceptable practice for a DCM to set spot-month limits pursuant to core principle 5 based on an analysis of estimated deliverable supplies.[414] Accordingly, the Commission is adopting estimated deliverable supply as the basis of setting spot-month limits.

The Commission proposes to adopt the 25 percent level of estimated deliverable supply for setting spot-month limits because, based on the Commission's surveillance and enforcement experience, this formula narrowly targets the trading that may be most susceptible to, or likely to facilitate, price disruptions. The Commission believes this spot month limit formula best maximizes the statutory objectives expressed in CEA section 4a(a)(3)(B) of preventing excessive speculation and market manipulation, ensuring market liquidity for bona fide hedgers, and promoting efficient price discovery. This formula is consistent with the longstanding acceptable practices for DCM core principle 5 which provide that, for physical-delivery contracts, the spot-month limit should not exceed 25 percent of the estimated deliverable supply.[415] The Commission believes, based on its experience and expertise, that the formula would be an effective

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deliverable supply in Core Principles and Other Requirements for Designated Contract Markets, Final Rule, 77 FR 36612, 36722, Jun. 19, 2012.

[414] See 17 CFR 150.5(b).

[415] Id.

prophylactic tool to reduce the threat of corners and squeezes, and promote convergence without compromising market liquidity.[416]

Furthermore, the Commission has observed generally low usage among all traders of the physical-delivery futures contract during the spot month, relative to the existing exchange spot-month position limits. Thus, the Commission infers that few, if any, traders offset the risk of swaps in physical-delivery futures contracts during the spot month with positions in excess of the exchange's current spot month limits.[417] The Commission invites comments as to the extent to which traders actually have offset the risk of swaps during the spot month in a physical-delivery futures contract with a position in excess of an exchange's spot-month position limit.

Additionally, the Commission imposes spot-month limits using the same formula to restrict the size of positions in cash-settled contracts that would potentially benefit from a trader's distortion of the price of the underlying referenced contract (or other cash price series) that serves as the basis of cash settlement.[418] The Commission has found that traders with positions in look-alike cash-settled contracts have an incentive to manipulate and undermine price discovery in the physical-delivery contract to which the cash-settled contract is linked by price. This practice is known as "banging" or "marking

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[416] The Commission also has established requirements for a DCM to monitor a physical-delivery contract's terms and conditions as they relate to the convergence between the futures contract price and the cash price of the underlying commodity. 17 CFR 38.252. See the preamble discussion of § 38.252 in the final part 38 rulemaking. 77 FR 36612, 36635, June 19, 2012. The spot month limits will be set at levels that target only extraordinarily large traders. For example, the spot month limit for CBOT Wheat will be set at 600 contracts. The contract size for CBOT Wheat is 5,000 bushels (~136 metric tons). The current price of a bushel of wheat is approximately $7 per bushel. Therefore, a speculative trader would be permitted to carry a ~$21 million position in wheat into the spot month under the proposed position limits regime.

[417] See 76 FR at 71635 (n. 100–01) (discussing data in CME natural gas contract).

[418] The Commission also has established requirements for DCMs to monitor the pricing of cash-settled contracts. 17 CFR 38.253.

the close,"[419] a manipulative practice that the Commission prosecutes and that this proposal seeks to prevent.[420]

In the final part 38 rulemaking, the Commission instructed DCMs, when estimating deliverable supplies, to take into consideration the individual characteristics of the underlying commodity's supply and the specific delivery features of the futures contract.[421] In this regard, the Commission notes that DCMs historically have set or maintained exchange spot month limits at levels below 25 percent of deliverable supply. Setting such a lower level of a spot month limit may also serve the objectives of preventing excessive speculation, manipulation, squeezes and corners, while ensuring sufficient market liquidity for bona fide hedgers in the view of the listing DCM and ensuring the price discovery function of the market is not disrupted. Hence, the Commission observes that there may be a range of spot month limits, including limits set at levels below 25 percent of deliverable supply, which may serve as practicable to maximize these policy objectives.

e. Setting levels of single-month and all-months-combined limits.

Proposed § 150.2(e)(4) explains how the Commission would calculate non-spot-month position limit levels, which the Commission proposes to fix no less frequently than every two calendar years. In contrast to spot month position limits which are set as a function of estimated deliverable supply, the formula for the non-spot-month position

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[419] Section 4c(a)(5) of the Act lists certain unlawful disruptive trading practices, including "any trading, practice, or conduct on or subject to the rules of a registered entity that … demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period." 7 U.S.C. 6c(a)(5)(B). "Banging" or "marking the close" is discussed in the Commission's Antidisruptive Practices Authority, Interpretive guidance and policy statement, 78 FR 31890, 31894–96, May 28, 2013.

[420] See, e.g., DiPlacido v. CFTC, 364 Fed. Appx. 657 (2d Cir. 2009) (upholding Commission finding that DiPlacido manipulated the market where DiPlacido's closing trades accounted for 14% of the market).

[421] See 77 FR 36611, 36723, Jun. 12, 2012. DCM estimates of deliverable supplies (and the supporting data and analysis) will continue to be subject to Commission review.

limits is based on total open interest for all referenced contracts in a commodity. The actual position limit level will be set based on a formula: 10 percent of the open interest for the first 25,000 contracts and 2.5 percent of the open interest thereafter.[422] The Commission has used the 10, 2.5 percent formula in administering the level of the legacy all-months position limits since 1999.[423] The Commission believes the non-spot month position limits would restrict the market power of a speculator that could otherwise be used to cause unwarranted price movements. The Commission solicits comment on its single-month and all-months-combined limits, including whether the proposed formula has effectively addressed and will continue to address the § 4a(a)(3) regulatory objectives.

The Commission also proposes to estimate average open interest in referenced contracts based on the largest annual average open interest computed for each of the past two calendar years, using either month-end open contracts or open contracts for each business day in the time period, as the Commission finds in its discretion to be reliable.

1) Initial levels

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[422] The Commission proposes to use the futures position limits formula (the 10, 2.5 percent formula) to determine non-spot-month position limits for referenced contracts. The 10, 2.5 percent formula is identified in 17 CFR 150.5(c)(2).

[423] See 64 FR 24038, 24039, May 5, 1999. The Commission applies the open interest criterion by using a formula that specifies appropriate increases to the limit level as a percentage of open interest. As the total open interest of a futures market increases, speculative position limit levels can be raised. The Commission proposed using the 10, 2.5 percent formula in 1992. See Revision of Federal Speculative Position Limits, Proposed Rules, 57 FR 12766, 12770, Apr. 13, 1992. The Commission implemented the 10, 2.5 percent formula in two steps, the first step in 1993 and the second step in 1999. See Revision of Federal Speculative Limits, Interim Final Rules, 58 FR 17973, 17978, Apr. 7, 1993. See also Establishment of Speculative Position Limits, 46 FR 50938, Oct. 16, 1981 ("[T]he prevention of large or abrupt price movements which are attributable to the extraordinarily large speculative positions is a congressionally endorsed regulatory objective of the Commission. Further, it is the Commission's view that this objective is enhanced by the speculative position limits since it appears that the capacity of any contract 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.").

For setting the levels of initial non-spot month limits, the Commission proposes to use open interest for calendar years 2011 and 2012 in futures contracts, options thereon, and in swaps that are significant price discovery contracts that are traded on exempt commercial markets.

Table 10. Open Interest and Calculated Limits by Core Futures Referenced Contract, January 1, 2011, to December 31, 2012

Commodity Type	Core Referenced Futures Contract	Year	Open Interest (Daily Average)	Open Interest (Month End)	Limit (Daily Average)	Limit (Month End)	Limit
Legacy Agricultural	CBOT Corn (C)	2011	2,063,231	1,987,152	53,500	51,600	53,500
		2012	1,773,525	1,726,096	46,300	45,100	
	CBOT Oats (O)	2011	15,375	15,149	1,600	1,600	1,600
		2012	12,291	11,982	1,300	1,200	
	CBOT Soybeans (S)	2011	822,046	798,417	22,500	21,900	26,900
		2012	997,736	973,672	26,900	26,300	
	CBOT Soybean Meal (SM)	2011	237,753	235,945	7,900	7,800	9,000
		2012	283,304	281,480	9,000	9,000	
	CBOT Soybean Oil (SO)	2011	392,658	382,100	11,700	11,500	11,900
		2012	397,549	388,417	11,900	11,600	
	CBOT Wheat (W)	2011	565,459	550,251	16,100	15,700	16,200
		2012	572,068	565,490	16,200	16,100	
	ICE Cotton No. 2 (CT)	2011	275,799	272,613	8,800	8,700	8,800
		2012	259,608	261,789	8,400	8,500	
	KCBT Hard Winter Wheat (KW)	2011	183,400	177,998	6,500	6,400	6,500
		2012	155,540	155,074	5,800	5,800	
	MGEX Hard Red Spring Wheat (MWE)	2011	55,938	54,546	3,300	3,300	3,300
		2012	40,577	40,314	2,900	2,900	

Commodity Type	Core Referenced Futures Contract	Year	Open Interest (Daily Average)	Open Interest (Month End)	Limit (Daily Average)	Limit (Month End)	Limit
Other Agricultural	CBOT Rough Rice (RR)	2011	21,788	21,606	2,200	2,200	2,200
		2012	15,262	14,964	1,600	1,500	
	CME Milk Class III (DA)	2011	55,567	57,490	3,300	3,400	3,400
		2012	47,378	47,064	3,100	3,100	
	CME Feeder Cattle (FC)	2011	44,611	43,730	3,000	3,000	3,000
		2012	44,984	43,651	3,000	3,000	
	CME Lean Hog (LH)	2011	284,211	288,281	9,000	9,100	9,400
		2012	296,822	297,882	9,300	9,400	
	CME Live Cattle (LC)	2011	433,581	440,229	12,800	12,900	12,900
		2012	409,501	417,037	12,200	12,400	
	ICUS Cocoa (CC)	2011	191,801	198,290	6,700	6,900	7,100
		2012	202,886	206,808	7,000	7,100	
	ICE Coffee C (KC)	2011	174,845	176,079	6,300	6,300	7,100
		2012	204,268	207,403	7,000	7,100	
	ICE FCOJ-A (OJ)	2011	37,347	36,813	2,900	2,800	2,900
		2012	30,788	29,867	2,700	2,700	
	ICE Sugar No. 11 (SB)	2011	814,234	806,887	22,300	22,100	23,500
		2012	855,375	862,446	23,300	23,500	
	ICE Sugar No. 16 (SF)	2011	11,532	11,662	1,200	1,200	1,200
		2012	10,485	10,530	1,100	1,100	
Energy	NYMEX Henry Hub Natural Gas (NG)	2011	4,831,973	4,821,859	122,700	122,500	149,600
		2012	5,905,137	5,866,365	149,600	148,600	
	NYMEX Light Sweet Crude Oil (CL)	2011	4,214,770	4,291,662	107,300	109,200	109,200
		2012	3,720,590	3,804,287	94,900	97,000	
	NYMEX NY Harbor ULSD (HO)	2011	559,280	566,600	15,900	16,100	16,100
		2012	473,004	485,468	13,800	14,100	

Commodity Type	Core Referenced Futures Contract	Year	Open Interest (Daily Average)	Open Interest (Month End)	Limit (Daily Average)	Limit (Month End)	Limit
	NYMEX RBOB Gasoline (RB)	2011	362,349	370,207	11,000	11,200	11,800
		2012	388,479	393,219	11,600	11,800	
Metals	COMEX Copper (HG)	2011	134,097	131,688	5,300	5,200	5,600
		2012	148,767	147,187	5,600	5,600	
	COMEX Gold (GC)	2011	782,793	746,904	21,500	20,600	21,500
		2012	685,618	668,751	19,100	18,600	
	COMEX Silver (SI)	2011	179,393	172,567	6,400	6,200	6,400
		2012	165,670	164,064	6,100	6,000	
	NYMEX Palladium (PA)	2011	22,327	22,244	2,300	2,300	5,000
		2012	23,869	24,265	2,400	2,500	
	NYMEX Platinum (PL)	2011	40,988	40,750	2,900	2,900	5,000
		2012	54,838	54,849	3,300	3,300	

Given the levels of open interest for the calendar years of 2011 and 2012 for futures contracts and for swaps that are significant price discovery contracts traded on exempt commercial markets, this formula would result in levels for non-spot month position limits that are high in comparison to the size of positions typically held in futures contracts.[424] Few persons held positions over the levels of the proposed position limits in the past two calendar years, as illustrated in Table 11 below. To provide the public with additional information regarding the number of large position holders in the past two calendar years, the table also provides counts of persons over 60, 80, 100, and 500

[424] A review of preliminary swap open interest reported under part 20 indicates that open interest in swap referenced contracts is low, in comparison to futures open interest. Any open interest in swap referenced contracts would serve to increase the levels of the positions limits.

percent of the levels of the proposed position limits. Note that the 500 percent line is omitted from Table 11 where no person held a position over that level.

Table 11. Unique Persons Over Percentages of Proposed Position Limit Levels, January 1, 2011, to December 31, 2012

Commodity Type/ Core Referenced Futures Contract	Percent of Level	Unique Persons Over Level			
		Spot Month (Physical-Delivery)	Spot Month (Cash-Settled)	Single Month	All Months
Legacy Agricultural					
CBOT Corn (C)	60	243	4	9	16
	80	167	*	6	8
	100	53	*	*	5
	500	7	--	--	--
CBOT Oats (O)	60	5	--	15	15
	80	4	--	8	9
	100	*	--	6	8
CBOT Soybeans (S)	60	119	--	14	17
	80	88	--	9	12
	100	27	--	6	8
	500	9	--	--	--
CBOT Soybean Meal (SM)	60	52	*	20	35
	80	32	*	9	16
	100	12	*	6	9
CBOT Soybean Oil (SO)	60	114	--	31	37
	80	70	--	15	20
	100	20	--	10	12
	500	*	--	--	--
CBOT Wheat (W)	60	46	--	22	32
	80	31	--	14	16
	100	14	--	9	12
	500	*	--	--	--
ICE Cotton No. 2 (CT)	60	12	--	16	19
	80	7	--	11	14
	100	6	--	9	11
	500	*	--	--	--
KCBT Hard Winter Wheat (KW)	60	33	--	36	40
	80	18	--	13	21
	100	14	--	9	13

	500	*	--	--	--
MGEX Hard Red Spring Wheat (MWE)	60	11	--	17	24
	80	10	--	11	15
	100	6	--	9	9
Other Agricultural					
CBOT Rough Rice (RR)	60	9	--	7	9
	80	6	--	5	5
	100	--	--	*	*
CME Milk Class III (DA)	60	NA	6	*	19
	80	NA	4	--	14
	100	NA	*	--	7
CME Feeder Cattle (FC)	60	NA	76	4	13
	80	NA	55	*	7
	100	NA	16	*	*
CME Lean Hog (LH)	60	NA	52	20	30
	80	NA	41	11	18
	100	NA	28	7	13
	500	NA	*	--	--
CME Live Cattle (LC)	60	37	--	13	27
	80	*	--	7	17
	100	*	--	4	12
ICUS Cocoa (CC)	60	*	--	24	29
	80	*	--	14	18
	100	*	--	10	12
ICE Coffee C (KC)	60	14	--	19	24
	80	13	--	8	14
	100	8	--	5	6
	500	2	--	--	--
ICE FCOJ-A (OJ)	60	8	--	13	16
	80	7	--	9	9
	100	6	--	6	7
ICE Sugar No. 11 (SB)	60	33	--	28	31
	80	23	--	20	24
	100	15	--	12	18
	500	*	--	--	--

ICE Sugar No. 16 (SF)	60	6	--	10	16
	80	5	--	7	14
	100	5	--	7	13
Energy					
NYMEX Henry Hub Natural Gas (NG)	60	177	221	*	5
	80	131	183	--	--
	100	61	148	--	--
	500	--	35	--	--
NYMEX Light Sweet Crude Oil (CL)	60	98	89	--	4
	80	72	62	--	*
	100	39	33	--	*
	500	--	--	--	--
NYMEX NY Harbor ULSD (HO)	60	76	45	9	18
	80	53	35	6	15
	100	33	24	5	8
	500	--	*	--	--
NYMEX RBOB Gasoline (RB)	60	71	45	21	30
	80	48	32	12	16
	100	30	22	7	11
	500	--	*	--	--
Metals					
COMEX Copper (HG)	60	14	--	29	28
	80	13	--	21	22
	100	*	--	16	16
COMEX Gold (GC)	60	13	--	24	21
	80	9	--	19	19
	100	5	--	12	12
COMEX Silver (SI)	60	5	--	25	21
	80	*	--	15	13
	100	*	--	10	9
NYMEX Palladium (PA)	60	6	--	5	5
	80	*	--	*	*
	100	*	--	*	*
NYMEX Platinum (PL)	60	11	--	15	18

	80	5	--	11	12
	100	*	--	9	10

Legend:
* means fewer than 4 unique owners exceeded the level.
-- means no unique owners exceeded the level.
NA means not applicable.[425]

The Commission has also reviewed preliminary data submitted to it under part 20. The Commission preliminarily has decided not to use the data currently reported under part 20 for purposes of setting the initial levels of the proposed single month and all-months-combined positions limits. Instead, the Commission is proposing to set initial levels based on open interest in futures, options on futures, and SPDC swaps. Thus, the proposed initial levels represent lower bounds for the initial levels the Commission may establish in final rules. The Commission is providing the public with average open positions reported under part 20 for the month of January 2013, in the table below. As discussed below, the data reported during the month of January 2013, reflected improved data reporting quality. However, the Commission is concerned that the longer time series of this data has been less reliable and thus has not used it for purposes of setting proposed initial position limit levels.

Table 12. Swaps Reported under Part 20 —Average Daily Open Positions, Futures Equivalent, January 2013

Covered Swap Contract	Uncleared Swaps	Cleared Swaps
Chicago Board of Trade ("CBOT") Corn	110,533	3,060
CBOT Ethanol	*	15,905

[425] Table notes: (1) aggregation exemptions were not used in computing the counts of unique persons; (2) the position data was for futures, futures options and swaps that are significant price discovery contracts (SPDCs).

CBOT Oats	--	--
CBOT Rough Rice	--	--
CBOT Soybean Meal	20,594	--
CBOT Soybean Oil	35,760	--
CBOT Soybeans	39,883	1,306
CBOT Wheat	64,805	2,856
Chicago Mercantile Exchange (“CME”) Butter	--	--
CME Cheese	--	--
CME Dry Whey	--	--
CME Feeder Cattle	*	--
CME Hardwood Pulp	--	--
CME Lean Hog	12,809	--
CME Live Cattle	17,617	--
CME Milk Class III	--	--
CME Non Fat Dry Milk	--	--
CME Random Length Lumbar	--	--
CME Softwood Pulp	--	--
Commodity Exchange, Inc. (“COMEX”) Copper Grade No. 1	9,259	--
COMEX Gold	38,295	--
COMEX Silver	5,753	--
ICE Futures U.S. (“ICE”) Cocoa	8,933	--
ICE Coffee C	3,465	--
ICE Cotton No. 2	14,627	--
ICE Frozen Concentrated Orange Juice	*	--
ICE Sugar No. 11	287,434	--
ICE Sugar No. 16	--	--
Kansas City Board of Trade (“KCBT”) Wheat	2,565	--
Minneapolis Grain Exchange (“MGEX”) Wheat	2,419	--

NYSE LIFFE ("NYL") Gold, 100 Troy Oz.	--	--
NYL Silver, 5000 Troy Oz.	--	--
New York Mercantile Exchange ("NYMEX") Cocoa	--	--
NYMEX Brent Financial	93,825	--
NYMEX Central Appalachian Coal	--	--
NYMEX Coffee	2,320	--
NYMEX Cotton	8,315	--
NYMEX Crude Oil, Light Sweet	507,710	--
NYMEX Gasoline Blendstock (RBOB).	10,110	--
NYMEX Hot Rolled Coil Steel	*	--
NYMEX Natural Gas	1,060,468	96,057
NYMEX No. 2 Heating Oil, New York Harbor	35,126	--
NYMEX Palladium	*	--
NYMEX Platinum	*	--

Legend:
* means fewer than 1,000 futures equivalent contracts reported in the category.
-- means no contracts reported.

The part 20 data are comprised of positions resulting from cleared and uncleared swaps, which are reported by different reporting entities. Clearing members of derivative clearing organizations ("DCOs") have reported paired swap positions in cleared swaps since November 11, 2011, and paired swap positions in uncleared swaps since January 20, 2012. DCOs have also reported aggregate positions of each clearing member's house and customer accounts for each paired swap since November 11, 2011. Data reports submitted by clearing members have had various errors (e.g., duplicate records, inconsistent reporting of data fields) — Commission staff continues to work with these reporting entities to improve data reporting.

Beginning March 1, 2013, swap dealers that were not clearing members were required to submit data reports under § 20.4(c). Additionally, some swap dealers began reporting such data voluntarily prior to March 1, 2013.[426] As these new reporters submitted position data reports, the Commission observed a substantial increase in open interest for uncleared swaps that appeared unreasonable; it became apparent that part of this increase was caused by data reporting errors.[427] The Commission believes it would be difficult to distinguish the true level of open interest because some reporting errors may cause open interest to be underestimated while others may cause open interest to be overestimated.

Alternatively, the Commission is considering using part 20 data, should it determine such data to be reliable, in order to establish higher initial levels in a final rule.[428] Further, the Commission is considering using data from swaps data repositories, as practicable. In either case, the Commission is considering excluding inter-affiliate swaps, since such swaps would tend to inflate open interest.

Based on the forgoing, the Commission believes the initial levels proposed herein should ensure adequate liquidity for hedges yet nevertheless prevent a speculative trader from acquiring excessively large positions above the limits, and thereby help to prevent excessive speculation and to deter and prevent market manipulation.

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[426] Further, other firms have begun to report under part 20 after March 1, 2013, following registration as swap dealers.

[427] For example, reported total open interest in swaps, both cleared and uncleared, linked to or based on NYMEX Natural Gas futures contracts averaged approximately 1.2 million contracts between January 1, 2013 and March 1, 2013 and approximately 97 million contracts between March 1 and May 31, 2013 (with a peak value close to 300 million contracts).

[428] Several reporting entities have submitted data that contained stark errors. For example, certain reporting entities submitted position sizes that the Commission determined to be 1000 times, or even 10,000 times, too large.

2) <u>Subsequent levels</u>

For setting subsequent levels of non-spot month limits, the Commission proposes to estimate average open interest in referenced contracts using data reported by DCMs and SEFs pursuant to parts 16, 20, and/or 45.[429] While the Commission does not currently possess all data needed to fully enforce the position limits proposed herein, the Commission believes that it should have adequate data to reset the overall concentration-based percentages for the position limits two years after initial levels are set.[430] The Commission intends to use comprehensive positional data on physical commodity swaps once such data is collected by swap data repositories under part 45, and would convert such data to futures-equivalent open positions in order to fix numerical position limits through the application of the proposed open-interest-based position limit formula. The resultant limits are purposely designed to be high enough to ensure sufficient liquidity for bona fide hedgers and to avoid disrupting the price discovery process given the limited information the Commission has with respect to the size of the physical commodity swap markets, including preliminary data collected under part 20 as of January 2013. The Commission further proposes to publish on the Commission's webpage such estimates of average open interest in referenced contracts on a monthly basis to make it easier for market participants to estimate changes in levels of position limits.

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[429] Options listed on DCMs would be adjusted using an option delta reported to the Commission pursuant to 17 CFR part 16; swaps would be counted on a futures equivalent basis, equal to the economically equivalent amount of core referenced futures contracts reported pursuant to 17 CFR part 20 or as calculated by the Commission using swap data collected pursuant to17 CFR part 45.

[430] While the Commission has access to some data on physical-commodity swaps from swaps data repositories, the Commission continues to work with SDRs and other market participants to fully implement the swaps data reporting regime.

f. Grandfather of pre-existing positions.

The Commission proposes in new § 150.2(f)(2) to conditionally exempt from federal non-spot-month speculative position limits any referenced contract position acquired by a person in good faith prior to the effective date of such limit, provided that such pre-existing referenced contract position is attributed to the person if such person's position is increased after the effective date of such limit.[431] This conditional exemption for pre-existing positions is consistent with the provisions of CEA section 4a(b)(2) in that it is designed to phase in position limits without significant market disruption, while attributing such pre-existing positions to the person if such person's position is increased after the effective date of a position limit is consistent with the provisions of CEA section 22(a)(5)(B). Notwithstanding this exemption for pre-existing positions in non-spot months, proposed § 150.2(f)(1) would require a person holding a pre-existing referenced contract position (in a commodity derivative contract other than a pre-enactment and transition period swaps as defined in proposed § 150.1) to comply with spot month speculative position limits.[432] The Commission remains particularly concerned about protecting the spot month in physical-delivery futures contracts from squeezes and corners.

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[431] Such pre-existing positions that are in excess of the proposed position limits would not cause the trader to be in violation based solely on those positions. To the extent a trader's pre-existing positions would cause the trader to exceed the non-spot-month limit, the trader could not increase the directional position that caused the positions to exceed the limit until the trader reduces the positions to below the position limit. As such, persons who established a net position below the speculative limit prior to the enactment of a regulation would be permitted to acquire new positions, but the Commission would calculate the combined position of a person based on pre-existing positions with any new position.

[432] Nothing in proposed § 150.2(f) would override the exemption set forth in proposed § 150.3(d) for pre-enactment and transition period swaps from speculative position limits. See discussion of proposed § 150.3(d) below.

Proposed § 150.2(g) would apply position limits to foreign board of trade ("FBOT") contracts that are both: (1) linked contracts, that is, a contract that settles against the price (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 United States through direct access to its electronic trading and order matching system through registration as an FBOT or via a staff no action letter.[433] Proposed § 150.2(g) is consistent with CEA section 4a(a)(6)(B), which directs the Commission to apply aggregate position limits to FBOT linked, direct-access contracts.[434]

3. Section 150.3 — Exemptions

i. Current § 150.3

CEA section 4a(c)(1) exempts bona fide hedging transactions or positions, which terms are to be defined by the Commission, from any rule promulgated by the Commission under CEA section 4a concerning speculative position limits.[435] Current § 150.3, adopted by the Commission before the Dodd-Frank Act was enacted, contains an exemption from federal position limits for bona fide hedging transactions.[436] Additionally, Dodd-Frank added section 4a(a)(7) to the CEA, which gives the

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[433] Proposed § 150.2(g) is identical in substance to vacated § 151.8. Compare 76 FR 71693.

[434] See supra discussion of CEA section 4a(a)(6) concerning aggregate position limits and the treatment of FBOT contracts.

[435] 7 U.S.C. 6a(c)(1).

[436] Bona fide hedging transactions and positions for excluded commodities are currently defined at 17 CFR § 1.3(z). As discussed above, the Commission has proposed a new comprehensive definition of bona fide hedging positions in proposed § 150.1.

Commission authority to provide exemptions from any requirement the Commission establishes under section 4a with respect to speculative position limits.[437]

The existing exemptions promulgated under pre-Dodd-Frank CEA section 4a and set forth in current § 150.3 are fundamental to the Commission's regulatory framework for speculative position limits. Current § 150.3 specifies the types of positions that may be exempted from, and thus may exceed, the federal speculative position limits. First, the exemption for bona fide hedging transactions and positions as defined in current § 1.3(z) permits a commercial enterprise to exceed positions limits to the extent the positions are reducing price risks incidental to commercial operations.[438] Second, the exemption for spread or arbitrage positions between single months of a futures contract (and/or, on a futures-equivalent basis, options) outside of the spot month, permits any trader's spread position to exceed the single month limit.[439] Third, positions carried for an eligible entity[440] in the separate account of an independent account controller ("IAC")[441] that

[437] 7 U.S.C. 6a(a)(7). Section 4a(a)(7) of the CEA provides the Commission plenary authority to grant exemptive relief from position limits. Specifically, under Section 4a(a)(7), the Commission "by rule, regulation, or order, may exempt, conditionally or unconditionally, any person, or class of persons, any swap or class of swaps, any contract of sale of a commodity for future delivery or class of such contracts, any option or class of options, or any transaction or class of transactions from any requirement it may establish . . . with respect to position limits."

[438] 17 CFR 150.3(a)(1). The current definition of bona fide hedging transactions and positions in 1.3(z) is discussed above.

[439] The Commission clarifies that a spread or arbitrage position in this context means a short position in a single month of a futures contract and a long position in another contract month of that same futures contract, outside of the spot month, in the same crop year. The short and/or long positions may also be in options on that same futures contract, on a futures equivalent basis. Such spread or arbitrage positions, when combined with any other net positions in the single month, must not exceed the all-months limit set forth in current § 150.2, and must be in the same crop year. 17 CFR 150.3(a)(3).

[440] "Eligible entity" is defined in current 17 CFR 150.1(d).

[441] "Independent account controller" is defined in 17 CFR 150.1(e).

manages customer positions need not be aggregated with the other positions owned or controlled by that eligible entity (the "IAC exemption").[442]

ii. Proposed § 150.3

In this release, the Commission proposes organizational and substantive amendments to § 150.3, generally resulting in an increase in the number of exemptions to speculative position limits. First, the Commission proposes to amend the three exemptions from federal speculative limits currently contained in § 150.3. These amendments would update cross references, relocate the IAC exemption and consolidate it with the Commission's separate proposal to amend the aggregation requirements of § 150.4,[443] and delete the calendar month spread provision which is unnecessary under proposed changes to § 150.2 that would increase the level of the single month position limits. Second, the Commission proposes to add exemptions from the federal speculative position limits for financial distress situations, certain spot-month positions in cash-settled referenced contracts, and grandfathered pre-Dodd-Frank and transition period swaps. Third, the Commission proposes to revise recordkeeping and reporting requirements for traders claiming any exemption from the federal speculative position limits.

a. Proposed amendments to existing exemptions

1) New cross-references

Because the Commission proposes to replace the definition of bona fide hedging in 1.3(z) with the definition in proposed § 150.1, proposed § 150.3(a)(1)(i) updates the

[442] See 17 CFR 150.3(a)(4). See also discussion of the IAC exemption in the Aggregation NPRM.

[443] See Aggregation NPRM.

cross-references to reflect this change.[444] Proposed §150.3(a)(3) would add a new cross-reference to the reporting requirements proposed to be amended in part 19.[445] As is currently the case for bona fide hedgers, persons who wish to claim any exemption from federal position limits, including hedgers, would need to satisfy the reporting requirements in part 19.[446] As discussed elsewhere in this release, the Commission is proposing amendments to update part 19 reporting.[447] For purposes of simplicity, the Commission is retaining the current placement of many reporting requirements, including those related to claimed exemptions from the federal position limits, within parts 15–21 of the Commission's regulations.[448] Lastly, proposed §150.3(i) would add a cross-reference to the updated aggregation rules in proposed § 150.4.[449] The Commission proposes to retain the current practice of considering entities required to aggregate accounts or positions under proposed § 150.4 to be the same person when determining whether they are eligible for a bona fide hedging position exemption.[450]

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[444] See supra discussion of the Commission's revised definition of bona fide hedging position in proposed § 150.1.

[445] See infra discussion of proposed revisions of 17 CFR part 19.

[446] See 17 CFR part 19.

[447] See infra discussion of proposed revisions of 17 CFR part 19.

[448] The Commission notes this is a change from the organization of vacated § 151.5, that included both exemptions and related reporting requirements in a single section.

[449] See Aggregation NPRM.

[450] See Aggregation NPRM. The Commission clarifies that whether it is economically appropriate for one entity to offset the cash market risk of an affiliate depends, in part, upon that entity's ownership interest in the affiliate. It would not be economically appropriate for an entity to offset all the risk of an affiliate's cash market exposure unless that entity held a 100 percent ownership interest in the affiliate. For less than a 100 percent ownership interest, it would be economically appropriate for an entity to offset no more than a pro rata amount of any cash market risk of an affiliate, consistent with the entity's ownership interest in the affiliate.

2) Deleting exemption for calendar spread or arbitrage positions

The Commission proposes to delete the exemption in current § 150.3(a)(3) for spread or arbitrage positions between single months of a futures contract or options thereon, outside the spot month.[451] The Commission has proposed to maintain the current practice in § 150.2, which the district court did not vacate, of setting single-month limits at the same levels as all-months limits, rendering the "spread" exemption unnecessary. The spread exemption set forth in current § 150.3(a)(3) permits a spread trader to exceed single month limits only to the extent of the all months limit.[452] Since proposed § 150.2 sets single month limits at the same level as all months limits, the spread exemption no longer provides useful relief. Furthermore, as discussed below in this release, the Commission would codify guidance in proposed § 150.5(a)(2)(B) that would allow a DCM or SEF to grant exemptions for intramarket and intermarket spread positions (as those terms are defined in proposed § 150.1) involving commodity derivative contracts subject to the federal limits.[453]

3) Relocating independent account controller ("IAC") exemption to proposed § 150.4

In a separate rulemaking, the Commission has proposed § 150.4(b)(5) to replace the existing IAC exemption in current § 150.3(a)(4).[454] Proposed § 150.4(b)(5) sets forth

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[451] In its entirety, 17 CFR 150.3(a)(3) sets forth an exemption from federal position limits for

> [s]pread or arbitrage positions between single months of a futures contract and/or, on a futures-equivalent basis, options thereon, outside of the spot month, in the same crop year; provided however, that such spread or arbitrage positions, when combined with any other net positions in the single month, do not exceed the all-months limit set forth in § 150.2.

[452] See id.

[453] As discussed above.

[454] For purposes of simplicity, the IAC exemption would be placed within the regulatory section providing for aggregation of positions. See Aggregation NPRM.

an exemption for accounts carried by an IAC that is substantially similar to current § 150.3(a)(4). Thus, the Commission is proposing to delete the IAC exemption in current § 150.3(a)(4) because it is duplicative.

b. Proposed additional exemptions from position limits

As discussed above, CEA section 4a(a)(7) provides that the Commission may "by rule, regulation, or order … exempt … any person or class of persons" from any requirement that the Commission may establish under section 4a of the Act. Pursuant to this authority, the Commission proposes to add new exemptions in § 150.3 for financial distress situations and qualifying positions in cash-settled referenced contracts. The Commission also proposes to add guidance to persons seeking exemptive relief for certain qualifying non-enumerated risk-reducing transactions. Additionally, the Commission proposes to grandfather pre-Dodd-Frank enactment swaps and transition swaps entered into before from position limits.

1) Financial distress exemption

The Commission proposes to add an exemption from position limits for certain market participants in certain financial distress scenarios to § 150.3(b). During periods of financial distress, it may be beneficial for a financially sound entity to take on the positions (and corresponding risk) of a less stable market participant. The Commission historically has provided for an exemption from position limits in these types of situations, to avoid sudden liquidations that could potentially reduce liquidity, disrupt price discovery, and/or increase systemic risk.[455] Therefore, the Commission now proposes to codify in regulation its prior exemptive practices to accommodate situations

[455] See Release 5551-08, "CFTC Update on Efforts Underway to Oversee Markets," September 19, 2008 (available at http://www.cftc.gov/PressRoom/PressReleases/pr5551-08).

involving, for example, a customer default at a FCM, or in the context of potential bankruptcy. The Commission historically has not granted such an exemption by Commission Order due to concerns regarding timeliness and flexibility. Furthermore, the Commission clarifies that this exemption for financial distress situations is not a hedging exemption.

2) Conditional spot month limit exemption

Proposed § 150.3(c) would provide a conditional spot-month limit exemption that permits traders to acquire positions up to five times the spot-month limit if such positions are exclusively in cash-settled contracts. This conditional exemption would only be available to traders who do not hold or control positions in the spot-month physical-delivery referenced contract. Historically, the Commission and Congress have been particularly concerned about protecting the spot month in physical-delivery futures contracts.[456] For example, new CEA section 4c(a)(5)(B) makes it unlawful for any person to engage in any trading, practice, or conduct on or subject to the rules of a registered entity that demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period. The Commission interprets the closing period to be defined generally as the period in the contract or trade when the settlement price is determined under the rules of a trading facility such as a DCM or SEF, and may include the time period in which a daily settlement price is determined and the expiration day for a futures contract.[457]

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[456] See, for example, the guidance for DCMs to establish a spot month limit in physical-delivery futures contracts that is no greater than 25 percent of estimated deliverable supply in 17 CFR 150.5(b).

[457] See Antidisruptive Practices Authority, Interpretive guidance and policy statement, 78 FR 31890, 31894, May 28, 2013. See also the discussion above of "banging the close" and the DiPlacido case.

This proposed conditional exemption for cash-settled contracts generally tracks exchange-set position limits currently implemented for certain cash-settled energy futures and swaps.[458] The Commission has examined market data on the effectiveness of conditional spot-month limits for cash-settled energy futures swaps, including the data submitted as part of the prior position limits rulemaking,[459] and preliminarily believes that the conditional approach effectively addresses the § 4a(a)(3) regulatory objectives. Since spot-month limit levels for cash-settled referenced contracts will be set at no more than 25% of the estimated spot-month deliverable supply in the relevant core referenced futures contract, the proposed conditional exemption would therefore permit a speculator to own positions in cash-settled referenced contracts equivalent to no more than 125% of the estimated deliverable supply.

As proposed, this broad conditional spot month limit exemption for cash-settled contracts would be similar to the conditional spot month limit for cash-settled contracts in

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[458] For example, this is the same methodology for spot-month speculative position limits that applies to cash-settled Henry Hub natural gas contracts on NYMEX and ICE, beginning with the February 2010 contract months (with the exception of the exchange-set requirement that a trader not hold large cash commodity positions). In response to concerns regarding increasing trading volumes in standardized swaps, in 2008 Congress amended section 2(h) of the Act to establish core principles for exempt commercial markets ("ECMs") trading swap contracts that the Commission determined to be significant price discovery contracts ("SPDCs"). 7 U.S.C. 2(h)(7) (2009). See also section 13201 of the Food, Conservation and Energy Act of 2008, H.R. 2419 (May 22, 2008). Core principle (IV) directed ECMs to "adopt, where necessary and appropriate, position limitations or position accountability for speculators… to reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month." 7 U.S.C. 2(h)(7)(C)(ii)(IV)(2009). Under the Commission's rules for ECMs trading SPDCs, the Commission provided an acceptable practice that an ECM trading a SPDC that is economically-equivalent to a contract traded on a DCM should set the spot-month limit at the same level as that specified for the economically-equivalent DCM contract. 17 CFR part 36 (2010). In practice, for example, ICE complied with this requirement by establishing a spot month limit for its natural gas SPDC at the same level as the spot month limit in the economically-equivalent NYMEX Henry Hub Natural Gas futures contract. Both ICE and NYMEX established conditional spot month limits in their cash-settled natural gas contracts at a level five times the level of the spot month limit in the physical-delivery futures contract.

[459] See 76 FR 71635 (n. 100–01)(discussing data for the CME natural gas contract).

proposed § 151.4.[460] However, unlike proposed § 151.4, proposed § 150.3(c) would not require a trader to hold physical commodity inventory of less than or equal to 25 percent of the estimated deliverable supply in order to qualify for the conditional spot month limit exemption. Rather, the Commission proposes to require enhanced reporting of cash market holdings of traders availing themselves of the conditional spot month limit exemption, as discussed in the proposed changes to part 19, below.[461] The Commission preliminarily believes that an enhanced reporting regime may serve to provide sufficient information to conduct an adequate surveillance program to detect and potentially deter excessively large positions or manipulative schemes involving the cash market.

The Commission notes that the proposed conditional spot month limit is a change of course from the expanded spot month limit that was only for natural gas referenced contracts in vacated § 151.4.[462] In proposing to expand the scope of derivatives contracts for which the conditional spot month limit is available, the Commission has reconsidered the risks to the market of permitting a speculative trader to hold an expanded position in a cash-settled contract when that speculative trader also is active in the underlying physical-delivery contract. The Commission preliminarily believes the conditional natural gas spot month limits of the exchanges generally have served to further the purposes Congress articulated for positions limits in sections 4a(a)(3)(B) and 4c(a)(5)(B)

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[460] With respect to cash-settled contracts, proposed § 151.4 incorporated a conditional spot-month limit permitting traders without a hedge exemption to acquire position levels that are five times the spot-month limit if such positions are exclusively in cash-settled contracts (i.e., the trader does not hold positions in the physical-delivery referenced contract) and the trader holds physical commodity positions that are less than or equal to 25 percent of the estimated deliverable supply. See Proposed Rule, 76 FR 4752, 4758, Jan. 26, 2011.

[461] See infra discussion of proposed revisions to part 19.

[462] Under vacated § 151.4, the Commission would have applied spot-month position limits for cash-settled contracts using the same methodology as applied to the physical-delivery core referenced futures contracts, with the exception of natural gas contracts, which would have a class limit and aggregate limit of five times the level of the limit for the physical-delivery Core Referenced Futures Contract. 76 FR 71635.

of the Act, such as deterring market manipulation, ensuring the price discovery function of the underlying market is not disrupted, and deterring disruptive trading during the closing period. The Commission notes those exchange-set conditional limits, as is the case for the proposed rule, prohibit a speculative trader who is holding an expanded position in a cash-settled contract from also holding any position in the physical-delivery contract.

The proposed conditional exemption would satisfy the goals set forth in CEA section 4a(a)(3)(B) by: eliminating all speculation in a physical-delivery contract during the spot period by a trader availing herself of the conditional spot month limit exemption; ensuring sufficient market liquidity in the cash-settled contract for bona fide hedgers, in light of the typically rapidly decreasing levels of open interest in the physical-delivery contract during the spot month as hedgers exit the physical-delivery contract; and protecting the price discovery process in the physical-delivery contract from the risk that traders with leveraged positions in cash-settled contracts (in comparison to the level of the limit in the physical-delivery contract) would otherwise attempt to mark the close or distort physical-delivery prices to benefit their leveraged cash-settled positions. Thus, the exemption would establish a higher conditional limit for cash-settled contracts than for physical delivery contracts, so long as such positions are decoupled from positions in physical delivery contracts which set or affect the value of such cash-settled positions.

The Commission preliminarily believes this proposed exemption would not encourage price discovery to migrate to the cash-settled contracts in a way that would make the physical-delivery contract more susceptible to sudden price movements near expiration. The Commission has observed, repeatedly, that open interest in physical-

delivery contracts typically declines markedly in the period immediately preceding the spot month. Open interest typically declines to minimal levels prior to the close of trading in physical-delivery contracts. The Commission notes a hedger with a long position need not stand for delivery when the price of a physical-delivery contract has adequately converged to the underlying cash market price; rather, such long position holder may offset and purchase needed commodities in the cash market at a comparable price that meets the hedger's specific location and quality needs. Similarly, the Commission notes a hedger with a short position need not give notice of intention to deliver and deliver when the price of a physical-delivery contract has adequately converged to the underlying cash market price; rather, such short position holder may offset and sell commodities held in inventory or current production in the cash market at a comparable price that is consistent with the hedger's specific storage location and quality of inventory or production.[463] Concerns regarding corners and squeezes are most acute in the markets for physical contracts in the spot month, which is why speculative limits in physical delivery markets are generally set at levels that are stricter during the spot month. The Commission seeks comment on whether a conditional spot-month limit exemption adequately protects the price discovery function of the underlying physical-delivery market. Further, the Commission solicits comment on its conditional spot month limit, including whether it is advisable to expand this conditional limit to all contracts.

[463] Once the price of a physical-delivery contract has converged adequately to cash market prices, long and short position holders typically offset physical-delivery contracts. Prior to such adequate convergence, the Commission has observed when a physical-delivery contract is trading at a price above prevailing cash market prices, commercials with inventory tend to sell contracts with the intent of making delivery, causing physical-delivery prices to converge to cash market prices. Similarly, the Commission has observed when a physical-delivery contract is trading at a price below prevailing cash market prices, commercials with a need for the commodity or merchants active in the cash market tend to buy the contract with the intent of taking delivery, causing physical-delivery prices to converge to cash market prices.

Additionally, the Commission solicits comment on whether the conditional spot-month limit has effectively addressed and will continue to address the CEA section 4a(a)(3) regulatory objectives. Are there other concerns or issues regarding the proposed conditional spot month limit exemption that the Commission has not addressed?

While traders who avail themselves of a conditional spot month limit exemption could not directly influence particular settlement prices by trading in the physical-delivery referenced contract, the Commission remains concerned about such traders' activities in the underlying cash commodity. Accordingly, the Commission proposes new reporting requirements in part 19, as discussed below.[464] The Commission invites comment and empirical analysis as to whether these reporting requirements adequately address concerns regarding: (1) protecting the price discovery function of the physical-delivery market, including deterring attempts to mark the close in the physical-delivery contract; and (2) providing adequate liquidity for bona fide hedgers in the physical-delivery contracts. In light of these two concerns, the Commission is also proposing alternatives to the conditional spot-month limit exemption, as discussed below, including the possibility that it would not adopt the proposed conditional spot-month limit exemption.

As one alternative to the proposed conditional spot month limit, the Commission is considering whether to restrict a trader claiming the conditional spot-month limit exemption to positions in cash-settled contracts that settle to an index based on cash-market transactions prices. This would prohibit traders from claiming a conditional exemption if the trader held positions in the spot-month of cash-settled contracts that

[464] See infra discussion of proposed revisions of part 19.

settle to prices based on the underlying physical-delivery futures contract. If the Commission adopted this alternative instead of the proposal, would the physical-delivery futures contract market be better protected? Why or why not?

The Commission is also considering a second alternative to the proposed conditional spot month limit: setting an expanded spot-month limit for cash-settled contracts at five times the level of the limit for the physical-delivery core referenced futures contract, regardless of positions in the underlying physical-delivery contract. This alternative would not prohibit a trader from carrying a position in the spot-month of the physical-delivery contract. Consequently, this alternative would give more weight to protecting liquidity for bona fide hedgers in the physical-delivery contract in the spot month, and less weight to protecting the price discovery function of the underlying physical-delivery contract in the spot month.[465] Given Congressional concerns regarding disruptive trading practices in the closing period, as discussed above, would this second alternative adequately address the policy factors in CEA section 4a(a)(3)(B)?

The Commission is also considering a third alternative: limiting application of an expanded spot-month limit to a trader holding positions in cash-settled contracts that settle to an index based on cash-market transactions prices. Under this third alternative, cash-settled contracts that settle to the underlying physical-delivery contract would be restricted by a spot-month limit set at the same level as that of the underlying physical-delivery contract. The Commission is considering an aggregate spot-month limit on all types of cash-settled contracts set at five times the level of the limit of the underlying

[465] This second alternative would effectively adopt for all commodity derivative contract limits certain provisions of vacated § 151.4 (that would have been applicable only to contracts in natural gas). As noted above, under vacated § 151.4, the Commission would have applied a spot-month position limit for cash-settled contracts in natural gas at a level of five times the level of the limit for the physical-delivery Core Referenced Futures Contract in natural gas. Id.

physical-delivery contract for this alternative to the proposed conditional spot month limit. Would this third alternative adequately address the policy factors in CEA section 4a(a)(3)(B)? Would this third alternative better address such policy factors than the second alternative?

The Commission requests comment on all aspects of the proposed conditional spot limit and the three alternatives discussed above, including whether conditional spot month limit exemptions should vary based on the underlying commodity. Should the Commission consider any other alternatives? If yes, please describe any alternative in detail. Would any of the proposed conditional spot month limit or the alternatives be more or less likely to increase or decrease liquidity in particular products? Would anti-competitive behavior be more or less likely to result from any of the proposed conditional spot month limit or the alternatives? Does any of the proposed conditional spot month limit or the alternatives increase the potential for manipulation? If yes, please provide detailed arguments and analyses.

3) <u>Exemption for pre-Dodd-Frank enactment swaps and transition period swaps</u>

Proposed § 150.3(d) would provide an exemption from federal position limits for (1) swaps entered into prior to July 21, 2010 (the date of the enactment of the Dodd-Frank Act of 2010), the terms of which have not expired as of that date, and (2) swaps entered into during the period commencing July 22, 2010, the terms of which have not expired as of that date, and ending 60 days after the publication of final § 150.3 in the Federal Register.[466] However, the Commission would allow both pre-enactment and

[466] This exemption is consistent with CEA section 4a(b)(2). The time period for transition swaps for purposes of position limits differs from the time period for transition swaps for purposes of swap data recordkeeping and reporting requirements. In both cases, the time periods for transition swaps begins on the date of enactment of the Dodd-Frank Act. However, the time periods for transition swaps end prior to

transition swaps to be netted with commodity derivative contracts acquired more than 60 after publication of final § 150.3 in the Federal Register for the purpose of complying with any non-spot-month position limit.

4) <u>Other exemptions for non-enumerated risk-reducing practices</u>

The Commission notes that the enumerated list of bona fide hedging positions as set forth in proposed § 150.1 represents an expanded list of exemptions that has evolved over many years of the Commission's experience in administering speculative position limits. The Commission has carefully expanded the list of exemptions in light of the statutory directive to define a bona fide hedging position in section 4a(c)(2) of the Act.

The Commission previously permitted a person to file an application seeking approval for a non-enumerated position to be recognized as a bona fide hedging position under § 1.47. The Commission proposes to delete § 1.47 for several reasons. First, § 1.47 did not provide guidance as to the standards the Commission would use to determine whether a position was a bona fide hedging position. Second, in the Commission's experience, the overwhelming number of applications filed under § 1.47 were from swap intermediaries seeking to offset the risk of swaps. Section 4a(c)(2) of the Act addresses the application of the bona fide hedging definition to certain positions that reduce risks attendant to a position resulting from certain swaps. As discussed in the definitions section above, those statutory provisions have been incorporated into the proposed definition of a bona fide hedging position under § 150.1; further, as discussed in the position limits section above, the provisions of proposed § 150.2 include relief outside of the spot month to permit automatic netting of swaps that are referenced contracts with

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the compliance date for each relevant rule. Swap data recordkeeping and reporting requirements for pre-enactment and transition period swaps are listed in 17 CFR part 46.

futures contracts that are referenced contracts and, where appropriate, to recognize as a bona fide hedging position the offset of certain non-referenced contract swaps with futures that are referenced contracts.[467] Third, § 1.47 provided specific, limited timeframes (of 30 days or 10 days) for the Commission to determine whether the position may be classified as bona fide hedging. The Commission preliminarily believes it should not constrain itself to such limited timeframes for review of potentially complex and novel risk-reducing transactions.

Nevertheless, the Commission proposes in § 150.3(e) to provide guidance to persons seeking exemptive relief. A person that engages in risk-reducing practices commonly used in the market that the person believes may not be included in the list of enumerated bona fide hedging transactions may apply to the Commission for an exemption from position limits. As proposed, market participants would be guided in § 150.3(e) first to consult proposed appendix C to part 150 to see whether their practices fall within a non-exhaustive list of examples of bona fide hedging positions as defined under proposed § 150.1.

A person engaged in risk-reducing practices that are not enumerated in the revised definition of bona fide hedging in proposed § 150.1 may use two different avenues to apply to the Commission for relief from federal position limits: the person may request an interpretative letter from Commission staff pursuant to § 140.99[468] concerning the

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[467] All the exemptions granted by the Commission pursuant to § 1.47 involving swaps were restricted to recognition of the futures offset as a bona fide hedging position only outside of the spot month.

[468] 17 CFR 140.99 defines three types of staff letters – exemptive letters, no-action letters, and interpretative letters – that differ in scope and effect. An interpretative letter is written advice or guidance by the staff of a division of the Commission or its Office of the General Counsel. It binds only the staff of the division that issued it (or the Office of the General Counsel, as the case may be), and third-parties may rely upon it as the interpretation of that staff. See description of CFTC Staff Letters, available at http://www.cftc.gov/lawregulation/cftcstaffletters/index.htm.

applicability of the bona fide hedging position exemption, or the person may seek exemptive relief from the Commission under section 4a(a)(7) of the Act.[469]

5) Previously granted risk management exemptions

Until about mid-2008, the Commission accepted and approved filings pursuant to § 1.3(z) and § 1.47 for recognition of transactions and positions described in such filings as bona fide hedging for purposes of compliance with Federal position limits. Since then, the Division of Market Oversight (the "Division"), on behalf of the Commission, has only considered revisions to previously recognized filings.[470] Prior to the Dodd-Frank Act and pursuant to authority delegated to it under § 140.97,[471] the Division recognized a broad range of transactions and positions as bona fide hedges based on facts and representations contained in such filings.[472] In seeking these determinations and exemptions from Federal position limits, filers would furnish information to demonstrate, among other things, that the described transactions and positions were economically

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[469] See supra discussion of CEA section 4a(a)(7).

[470] On May 29, 2008, the Commission announced a number of initiatives to increase transparency of the energy futures markets. In particular, the Commission would review the trading practices of index traders in the futures markets. CFTC Press Release 5503-08, May 29, 2008, available at http://www.cftc.gov/PressRoom/PressReleases/pr5503-08. On June 3, 2008, the Commission announced policy initiatives aimed at addressing concerns raised at an April 22, 2008 roundtable regarding events affecting the agricultural futures markets. Among other things, the Commission withdrew proposed rulemakings that would have increased the Federal speculative position limits on certain agricultural futures contracts and created a risk-management hedge exemption from the Federal speculative position limits for agricultural futures and options contracts. At the time, Acting Chairman Lukken and Commissioners Dunn, Sommers and Chilton said, ". . . the Commission will be cautious and guarded before granting additional exemptions in this area." CFTC Press Release 5504-08, June 3, 2008, available at http://www.cftc.gov/PressRoom/PressReleases/pr5504-08.

[471] 17 CFR 140.97.

[472] Almost all requests pursuant to § 1.47 have been for "risk-management" exemptions. See generally Risk Management Exemptions from Speculative Position Limits Approved under Commission Regulation 1.61, 52 FR 34633, Sep. 14, 1987; Clarification of Certain Aspects of the Hedging Definition, 52 FR 27195, Jul. 20, 1987. The Commission first approved a request for a risk-management exemption in 1991. The Commission has also approved a request by a foreign government to recognize certain positions associated with a governmental agricultural support program that would be consistent with the examples of bona fide hedging positions in proposed appendix B to part 150.

appropriate to the reduction of risk exposure attendant to the conduct and management of a commercial enterprise.[473] On this basis, the Division provided relief to dealers, market makers and "risk intermediaries" facing not only producers and consumers of commodities but hedge funds, pension funds and other financial institutions who lacked the capacity to make or take delivery of, or otherwise handle, a physical commodity.[474] The exemptions granted by the Division were not limited to futures to offset price risks associated with commodity index swaps that could be hedged in the component futures contracts. Filers obtained exemptions for futures transactions used to hedge price risks from transactions involving options, warrants, certificates of deposit, structured notes and various other structured products and hybrid instruments referencing commodities or embedding transactions linked to the payout or performance of a commodity or basket of commodities (collectively, "financial products"). In sum, the Division provided relief to "persons using the futures markets to manage risks associated with financial investment portfolios" and granted exemptions from speculative position limits to a broad range of "trading strategies to reduce financial risks, regardless of whether a matching transaction ever took place in a cash market for a physical commodity."[475] In recognizing such

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[473] Section 1.3(z)(1) includes the language, "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise." 17 CFR 1.3(z)(1). Section 1.47(b)(2) includes the language, "economically appropriate to the reduction of risk exposure attendant to the conduct and management of a commercial enterprise." 17 CFR 1.47(b)(2).

[474] The Commission notes that both the filings received by the Commission requesting such exemptions and the responding exemption letters issued by the Division are confidential in light of section 8 of the Act since, as noted above, the filings included information that described transactions and positions in order to demonstrate, among other things, that the transactions and positions were economically appropriate to the reduction of risk exposure attendant to the conduct and management of a commercial enterprise, while the Division's responding letters included information regarding the nature of the price risks that the transactions would entail.

[475] Staff Report, S. Permanent Subcomm. on Investigations, "Excessive Speculation in the Wheat Market," S. Hrg. 111-155 (Jul. 21, 2009) at 13 ("Wheat Report"). The Wheat Report was issued before the Dodd-Frank Act became law.

trading strategies as bona fide hedges, the Commission was responding to Congressional direction[476] to update its approach at a time when many sought to encourage what was then thought to be benign or beneficial financial innovation. In hindsight, the sum of these determinations may have exceeded what would be appropriate "to permit producers, purchasers, sellers, middlemen, and users of a commodity or product derived therefrom to hedge their legitimate anticipated business needs" and adequate "to prevent unwarranted price pressures by large hedgers."[477]

The Commission now proposes a definition of bona fide hedging position that would apply to all referenced contracts, and proposes to remove § 1.47.[478] The Commission is also proposing in § 150.3(f) that risk-management exemptions granted by the Commission under § 1.47 shall not apply to swap positions entered into after the effective date of a final position limits rulemaking, i.e., revoking the exemptions for new swap positions.[479] This means that certain transactions and positions (and, by extension,

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[476] See generally CFTC Staff Report on Commodity Swap Dealers & Index Traders with Commission Recommendations (Sep. 2008) at 13-15 ("Index Trading Report").

[477] 7 U.S.C. 6a(c)(1).

[478] Section 1.3(z), the definition of bona fide hedging transactions and positions for excluded commodities, was revised (but retained as amended) by the vacated part 151 Rulemaking. Section 1.47 of the Commission's regulations was removed and reserved by the vacated part 151 Rulemaking. On September 28, 2012, the District Court for the District of Columbia vacated the part 151 Rulemaking with the exception of the amendments to § 150.2. 887 F. Supp. 2d 259 (D.D.C. 2012). Vacating the part 151 Rulemaking, with the exception of the amendments to § 150.2, means that as things stand now, it is as if the Commission had never adopted any part of the part 151 Rulemaking other than the amendments to § 150.2. That is, the definition of bona fide hedging transactions and positions in § 1.3(z) remains unchanged, and § 1.47 is still in effect. As discussed above, the new definition of bona fide hedging positions in proposed § 150.1 is different from the changes to § 1.3(z) adopted by the Commission in the vacated part 151 Rulemaking. See 76 FR 71683–84. The Commission proposes to delete § 1.47 for several reasons, as discussed above. Proposed § 150.3(e) would provide guidance for persons seeking non-enumerated hedging exemptions through filing of a petition under section 4a(a)(7) of the Act, 7 U.S.C. 6a(a)(7), replacing the current process, as discussed above, under § 1.3(z)(3) and § 1.47 of the Commission's regulations.

[479] This approach is consistent with the limited exemption to provide for transition into position limits for persons with existing § 1.47 exemptions under vacated § 151.9(d) adopted in the vacated part 151 Rulemaking. See 76 FR 71655–56. This limited grandfather is similarly designed to limit market disruption.

persons party to such transactions or holding such positions) heretofore exempt from Federal position limits may be subject to Federal position limits. This is because some transactions and positions previously characterized as "risk-management" and recognized as bona fide hedges are inconsistent with the revised definition of bona fide hedging positions proposed in this release and the purposes of the Dodd-Frank Act amendments to the CEA.[480] As noted above, some pre-Dodd-Frank Act exemptions recognized offsets of risks from financial products. But the Commission now proposes to incorporate the "temporary substitute" test of section 4a(c)(2)(A)(i) of the Act in paragraph (2)(i) of the proposed definition of bona fide hedging position.[481] Financial products are not substitutes for positions taken or to be taken in a physical marketing channel. Thus, the offset of financial risks arising from financial products is inconsistent with the proposed definition of bona fide hedging for physical commodities. Moreover, the Commission interprets CEA section 4a(c)(2)(B) as a direction from Congress to narrow the scope of what constitutes a bona fide hedge.[482] Other things being equal, a narrower definition of bona fide hedging would logically subject more speculative positions to Federal limits.

Many of the Commission's bona fide hedging exemptions prior to the Dodd-Frank Act provided relief from Federal speculative position limits for persons acting as

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[480] Section 4a(c)(1) of the CEA authorizes the Commission to define bona fide hedging transactions or positions "consistent with the purposes of this Act." 7 U.S.C. 6a(c)(1).

[481] Section 4a(c)(2)(A)(i) of the Act provides that the Commission shall define what constitutes a bona fide hedging position as a position that represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel. 7 U.S.C. 6a(c)(2)(A)(i). The proposed definition of bona fide hedging position requires that, for a position in a commodity derivative contracts in a physical contract to be a bona fide hedging position, such position must represent a substitute for transactions made or to be made or positions taken or to be taken, at a later time in a physical marketing channel. See supra discussion of the temporary substitute test.

[482] See discussion above.

intermediaries in connection with index trading activities.[483] For example, a pension fund enters into a swap to receive the rate of return on a particular commodity index (such as the Standard & Poor's–Goldman Sachs Commodity Index or the Dow Jones–UBS Commodity Index) with a swap dealer. The pension fund thus has a synthetic long position in the index. The swap dealer, in turn, must pay the rate of return on the index to the pension fund, and purchases commodity futures contracts to hedge its short exposure to the index. Prior to the Dodd-Frank Act, the swap dealer might have obtained a bona fide hedge exemption for its position. This would no longer be the case.

The effect of revoking these exemptions for intermediaries may be mitigated in part by the absence of class limits in the proposed rules.[484] The absence of class limits

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[483] Index trading activities have emerged as an area of special concern to both Congress and the Commission. See generally the Wheat Report and the Index Trading Report. The Commission continues to consider the concerns of commenters who argue that some transactions and positions recognized before the Dodd-Frank Act as bona fide hedging may, in fact, facilitate excessive speculation. See, e.g., Testimony of Michael W. Masters before the Commodity Futures Trading Commission, Aug. 5, 2009, available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/hearing080509_masters.pdf; Comment Letter from Better Markets, Inc., Mar. 28, 2013, available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=34010&SearchText=Better%20Markets. The speculative position limits that the Commission now proposes do not directly address these concerns as they relate to commodity index funds, commodity index speculation and passive investment in the commodity derivatives markets. The speculative position limits that the Commission proposes apply only to transactions involving one commodity or the spread between two commodities (e.g., the purchase of one delivery month of one commodity against the sale of that same delivery month of a different commodity). They do not apply to diversified commodity index contracts involving more than two commodities. This means that index speculators remain unconstrained on the size of positions in diversified commodity index contracts that they can accumulate so long as they can find someone with the capacity to take the other side of their trades. These commenters assert that such contracts, which this proposal does not address, consume liquidity and damage the price discovery function of the market. Contra Bessembinder et al., "Predatory or Sunshine Trading? Evidence from Crude Oil Rolls" (working paper, 2012) available at http://business.nd.edu/uploadedFiles/Faculty_and_Research/Finance/Finance_Seminar_Series/2012%20Fall%20Finance%20Seminar%20Series%20-%20Hank%20Bessembinder%20Paper.pdf.

[484] In the vacated part 151 Rulemaking Proposal, the Commission proposed to create two classes of contracts for non-spot month limits: (1) Futures and options on futures contracts and (2) swaps. The proposed part 151 rule would have applied single-month and all-months-combined position limits to each class separately. The aggregate position limits across contract classes would have been in addition to the position limits within each contract class. The class limits were designed to diminish the possibility that a trader could have market power as a result of a concentration in any one submarket and to prevent a trader that had a flat net aggregate position in futures and swap from establishing extraordinarily large offsetting positions. 76 FR at 71642. In response to comments received on the proposed part 151 rule, the

means that market participants will be able to net economically equivalent derivatives contracts that are referenced contracts, i.e., futures against swaps, outside of the spot month, which would have the effect of reducing the size of a net position, perhaps below applicable speculative limits, in the case of an intermediary who enters into multiple swap positions in individual commodities to replicate a desired commodity index exposure in lieu of executing a swap on the commodity index .[485] Netting would also permit larger speculative positions in futures alone outside of the spot month for traders who did not previously have a bona fide hedge exemption, but who have positions in swaps in the same commodity that would be netted against futures in the same commodity.[486] Declining to impose class limits might seem to be at cross-purposes with narrowing the scope of the bona fide hedging definition. However, the Commission is concerned that class limits could impair liquidity in futures or swaps, as the case may be. For example, a speculator with a large portfolio of swaps near a particular class limit would be assumed to have a strong preference for executing futures transactions in order

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Commission determined to eliminate class limits from the final rule. This is because the Commission believed that comments regarding the ability of market participants to net swaps and futures positions that are economically equivalent had merit. The Commission believed that concerns regarding the potential for market abuses through the use of futures and swaps positions could be addressed adequately, for the time being, by the Commission's large trader surveillance program. The Commission stated in the vacated part 151 Rulemaking that it would closely monitor speculative positions in Referenced Contracts and may revisit this issue as appropriate. 76 FR 71643. The Commission has determined to omit class limits from the rules proposed in this release for the same reasons that it eliminated class limits in the vacated part 151 Rulemaking.

[485] Netting of commodity index contracts with referenced contracts would not be permitted because a commodity index contract is not a substitute for a position taken or to be taken in a physical marketing channel.

[486] For example, a swap intermediary seeking to manage price risk on its books from serving as a counterparty to swap clients in commodity index swap contracts or commodity swap contracts could establish a portfolio of long futures positions in the commodities in the index or the commodity underlying the swap above applicable speculative limits if it had obtained a risk-management exemption. If the Commission adopts this proposal, the intermediary would not be able to hedge above the limits pursuant to the exemption, but could net economically equivalent contracts, which would have the effect of reducing the size of the position below applicable speculative limits.

to maintain a swaps position below the class limit. If there were many similarly situated speculators, the market for such swaps could become less liquid. The absence of class limits should decrease the possibility of illiquid markets for contracts subject to Federal speculative position limits. Economically equivalent swaps and futures contracts outside of the spot month are close substitutes for each other. The absence of class limits should allow greater integration between the swaps and futures markets for contracts subject to Federal speculative position limits, and should also provide market participants with more flexibility when both hedging and speculating.

c. <u>Proposed recordkeeping requirements</u>

Proposed § 150.3(g) specifies recordkeeping requirements for persons who claim any exemption set forth in proposed § 150.3. Persons claiming exemptions under proposed § 150.3 must maintain complete books and records concerning all details of their related cash, forward, futures, options and swap positions and transactions.[487] Furthermore, such persons must make such books and records available to the Commission upon request under proposed § 150.3(h), which would preserve the "special call" rule set forth in current §150.3(e). This "special call" rule sets forth that any person claiming an exemption under § 150.3 must, upon request, provide to the Commission such information as specified in the call relating to the positions owned or controlled by that person; trading done pursuant to the claimed exemption; the commodity derivative

[487] Such positions and transactions include anticipated requirements, production and royalties, contracts for services, cash commodity products and by-products, and cross-commodity hedges.

contracts or cash market positions which support the claim of exemption; and the relevant business relationships supporting a claim of exemption.[488]

The proposed rules concerning detailed recordkeeping and special calls would help to ensure that any person who claims any exemption set forth in § 150.3 can demonstrate a legitimate purpose for doing so.

4. Part 19 — Reports by persons holding bona fide hedge positions pursuant to § 150.1 of this chapter and by merchants and dealers in cotton

i. Current part 19

The market and large trader reporting rules are contained in parts 15 through 21 of the Commission's regulations.[489] Collectively, these reporting rules effectuate the Commission's market and financial surveillance programs by providing information concerning the size and composition of the commodity futures, options, and swaps markets, thereby permitting the Commission to monitor and enforce the speculative position limits that have been established, among other regulatory goals. The Commission's reporting rules are implemented pursuant to the authority of CEA sections 4g and 4i, among other CEA sections. Section 4g of the Act imposes reporting and recordkeeping obligations on registered entities, and obligates FCMs, introducing brokers, floor brokers, and floor traders to file such reports as the Commission may require on proprietary and customer positions executed on any board of trade.[490] Section

[488] In order to capture information relating to swaps positions, the term "futures, options" in 17 CFR 150.3(e) would be replaced in proposed § 150.3(g) with the broader term "commodity derivative contracts" (defined in proposed § 150.1).

[489] 17 CFR parts 15–21.

[490] See CEA section 4g(a); 7 U.S.C. 6g(a).

4i of the Act requires the filing of such reports as the Commission may require when positions equal or exceed Commission-set levels.[491]

Current part 19 of the Commission's regulations sets forth reporting requirements for persons holding or controlling reportable futures and option positions which constitute bona fide hedge positions as defined in § 1.3(z) and for merchants and dealers in cotton holding or controlling reportable positions for future delivery in cotton.[492] In the several markets with federal speculative position limits — namely those for grains, the soy complex, and cotton — hedgers that hold positions in excess of those limits must file a monthly report pursuant to part 19 on CFTC Form 204: Statement of Cash Positions in Grains,[493] which includes the soy complex, and CFTC Form 304 Report: Statement of Cash Positions in Cotton.[494] These monthly reports, collectively referred to as the Commission's "series '04 reports," must show the trader's positions in the cash market and are used by the Commission to determine whether a trader has sufficient cash positions that justify futures and option positions above the speculative limits.[495]

ii. Proposed amendments to part 19

The Commission proposes to amend part 19 so that it conforms with the Commission's proposed changes to part 150. First, the Commission proposes to amend

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[491] See CEA section 4i; 7 U.S.C. 6i.

[492] See 17 CFR part 19. Current part 19 cross-references a provision of the definition of reportable position in 17 CFR 15.00(p)(2). As discussed below, that provision would be incorporated into proposed § 19.00(a).

[493] Current CFTC Form 204: Statement of Cash Positions in Grains is available at http://www.cftc.gov/ucm/groups/public/@forms/documents/file/cftcform204.pdf.

[494] Current CFTC Form 304 Report: Statement of Cash Positions in Cotton is available at http://www.cftc.gov/ucm/groups/public/@forms/documents/file/cftcform304.pdf.

[495] In addition, in the cotton market, merchants and dealers file a weekly CFTC Form 304 Report of their unfixed-price cash positions, which is used to publish a weekly Cotton On-call report, a service to the cotton industry. The Cotton On-Call Report shows how many unfixed-price cash cotton purchases and sales are outstanding against each cotton futures month.

part 19 by adding new and modified cross-references to proposed part 150, including the new definition of bona fide hedging position in proposed § 150.1. Second, the Commission proposes to amend § 19.00(a) by extending reporting requirements to any person claiming any exemption from federal position limits pursuant to proposed § 150.3. The Commission proposes to add three new series '04 reporting forms to effectuate these additional reporting requirements. Third, the Commission proposes to update the manner of part 19 reporting. Lastly, the Commission proposes to update both the type of data that would be required in series '04 reports, as well as the time allotted for filing such reports.

For purposes of clarity and simplicity, the Commission seeks to retain the current organization of grouping many reporting requirements, including those related to claimed exemptions from the federal position limits, within parts 15–21 of the Commission's regulations. The Commission notes this is a change from the organization of vacated § 151.5, which included both exemptions and related reporting requirements within a single section.

a. <u>Amended cross-references</u>

As discussed above, the Commission has proposed to replace the definition of bona fide hedging transaction found in § 1.3(z) with a new proposed definition of bona fide hedging position in proposed § 150.1. Therefore, proposed part 19 would replace cross-references to § 1.3(z) with cross-references to the new definition of bona fide hedging positions in proposed § 150.1.

Proposed part 19 will be expanded to include reporting requirements for positions in swaps, in addition to futures and options positions, for any part of which a person

relies on an exemption. Therefore, positions in "commodity derivative contracts," as defined in proposed § 150.1, would replace "futures and option positions" throughout amended part 19 as shorthand for any futures, option, or swap contract in a commodity (other than a security futures product as defined in CEA section 1a(45)).[496] This amendment would harmonize the reporting requirements of part 19 with proposed amendments to part 150 that encompass swap transactions.

Proposed § 19.00(a) would eliminate the cross-reference to the definition of reportable position in § 15.00(p)(2). In this regard, the current reportable position definition essentially identifies futures and option positions in excess of speculative position limits. Proposed § 19.00(a) simply makes clear that the reporting requirement applies to commodity derivative contract positions (including swaps) that exceed speculative position limits, as discussed below.

b. <u>List of persons who must file series '04 reports extended to include any person claiming an exemption under proposed § 150.3</u>

The reporting requirements of current part 19 apply only to persons holding bona fide hedge positions and merchants and dealers in cotton holding or controlling reportable positions for future delivery in cotton.[497] The Commission proposes to extend the reach of part 19 by requiring all persons who wish to avail themselves of any exemption from federal position limits under proposed § 150.3 to file applicable series '04 reports.[498] Collection of this information would facilitate the Commission's surveillance program

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[496] <u>See</u> discussion above.

[497] <u>See</u> 17 CFR part 19. Current part 19 cross-references the definition of reportable position in 17 CFR 15.00(p).

[498] Furthermore, anyone exceeding the federal limits who has received a special call must file a series '04 form.

with respect to detecting and deterring trading activity that may tend to cause sudden or unreasonable fluctuations or unwarranted changes in the prices of the referenced contracts and their underlying commodities. By broadening the scope of persons who must file series '04 reports, the Commission seeks to ensure that any person who claims any exemption from federal speculative position limits can demonstrate a legitimate purpose for doing so. The list of positions set forth in proposed § 150.3 that are eligible for exemption from the federal position includes, but is not limited to, bona fide hedging positions (including pass-through swaps and anticipatory bona fide hedge positions), qualifying spot month positions in cash-settled referenced contracts, and qualifying non-enumerated risk-reducing transactions.

Series '04 reports currently refers to Form 204 and Form 304, which are listed in current § 15.02.[499] The Commission proposes to add three new series '04 reporting forms to effectuate the expanded reporting requirements of part 19. The Commission will avoid using any form numbers with "404" to avoid confusion with the part 151 Rulemaking.[500] Proposed Form 504 would be added for use by persons claiming the conditional spot month limit exemption pursuant to proposed § 150.3(c).[501] Proposed Form 604 would be added for use by persons claiming a bona fide hedge exemption for either of two specific pass-through swap position types, as discussed further below.[502] Proposed Form 704

[499] 17 CFR 15.02.

[500] Forms 404, 404A and 404S were required under provisions of vacated part 151.

[501] See supra discussion of proposed § 150.3(c).

[502] Proposed Form 604 would replace Form 404S (as contemplated in vacated part 151).

would be added for use by persons claiming a bona fide hedge exemption for certain anticipatory bona fide hedging positions.[503]

c. Manner of reporting

1) Excluding certain source commodities, products or byproducts of the cash commodity hedged

For purposes of reporting cash market positions under current part 19, the Commission historically has allowed a reporting trader to "exclude certain products or byproducts in determining his cash positions for bona fide hedging" if it is "the regular business practice of the reporting trader" to do so.[504] The Commission has determined to clarify the meaning of "economically appropriate" in light of this reporting exclusion of certain cash positions.[505] In order for a position to be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, the enterprise generally should take into account all inventory or products that the enterprise owns or controls, or has contracted for purchase or sale at a fixed price. For example, in line with its historical approach to the reporting exclusion, the Commission does not believe that it would be economically appropriate to exclude large quantities of a source commodity held in inventory when an enterprise is calculating its value at risk to a source commodity and it intends to establish a long derivatives position as a hedge of unfilled

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[503] The updated definition of bona fide hedging in proposed § 150.1 incorporates several specific types of anticipatory transactions: unfilled anticipated requirements, unsold anticipated production, anticipated royalties, anticipated services contract payments or receipts, and anticipatory cross-commodity hedges. See, paragraphs (3)(iii), (4)(i), (iii), and (iv), and (5), respectively, of the Commission's amended definition of bona fide hedging transactions in proposed § 150.1 as discussed above.

[504] See 17 CFR 19.00(b)(1) (providing that "[i]f the regular business practice of the reporting trader is to exclude certain products or byproducts in determining his cash position for bona fide hedging . . . , the same shall be excluded in the report").

[505] See supra discussion of the "economically appropriate test" as it relates to the definition of bona fide hedging position.

anticipated requirements. Therefore, under proposed § 19.00(b)(1), a source commodity itself can only be excluded from a calculation of a cash position if the amount is de minimis, impractical to account for, and/or on the opposite side of the market from the market participant's hedging position.[506]

Originally, the Commission intended for the optional part 19 reporting exclusion to cover only cash positions that were not capable of being delivered under the terms of any derivative contract.[507] The Commission differentiated between "products and byproducts" of a commodity and the underlying commodity itself, the former capable of exclusion from part 19 reporting under normal business practices due to the absence of any derivative contract in such product or byproduct.[508] This intention ultimately evolved to allow cross-commodity hedging of products and byproducts of a commodity that were not necessarily deliverable under the terms of any derivative contract.[509] The instructions to current Form 204 go a step further than current § 19.00(b)(1) by allowing for a reporting trader to exclude "certain **source commodities**, products, or byproducts in determining [ ] cash positions for bona fide hedging." (Emphasis added.)

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[506] Proposed § 19.00(b)(1) adds a caveat to the alternative manner of reporting: when reporting for the cash commodity of soybeans, soybean oil, or soybean meal, the reporting person shall show the cash positions of soybeans, soybean oil and soybean meal. This proposed provision for the soybean complex is included in the current instructions for preparing Form 204.

[507] 43 FR 45825, 45827, Oct. 4, 1978 (explaining that the allowance for eggs not kept in cold storage to be excluded from reporting a cash position in eggs under part 19 "was appropriate when the only futures contract being traded in fresh shell eggs required delivery from cold storage warehouses.").

[508] Prior to the Commission revising the part 19 reporting exclusion for eggs, see id., the exclusion allowed "eggs not in cold storage **or certain egg products**" not to be reported as a cash position. 26 FR 2971, Apr. 7, 1961 (emphasis added). Additionally, the title to the revised exclusion reads: "Excluding products or byproducts of the cash commodity hedged." See 43 FR 45825, 45828, Oct. 4, 1978. So, in addition to a commodity itself that was not deliverable under any derivative contract, the Commission also recognized a separate class of "products and byproducts" that resulted from the processing of a commodity that it did not believe at the time was capable of being hedged by any derivative contract for purposes of a bona fide hedge.

[509] See 42 FR 42748, Aug. 24, 1977. Cross-commodity hedging is discussed as an enumerated hedge, below.

The Commission's proposed clarification of the § 19.00(b)(1) reporting exclusion would prevent the definition of bona fide hedging positions in proposed § 150.1 from being swallowed by this reporting rule. For it would not be economically appropriate behavior for a person who is, for example, long derivative contracts to exclude inventory when calculating unfilled anticipated requirements. Such behavior would call into question whether an offset to unfilled anticipated requirements is, in fact, a bona fide hedging position, since such inventory would fill the requirement. As such, a trader can only underreport cash market activities on the opposite side of the market from her hedging position as a regular business practice, unless the unreported inventory position is de minimis or impractical to account for. By way of example, the alternative manner of reporting in proposed § 19.00(b)(1) would permit a person who has a cash inventory of 5 million bushels of wheat, and is short 5 million bushels worth of commodity derivative contracts, to underreport additional cash inventories held in small silos in disparate locations that are administratively difficult to count. This person could instead opt to calculate and report these hard-to-count inventories and establish additional short positions in commodity derivative contracts as a bona fide hedge against such additional inventories.

2) <u>Cross-commodity hedges</u>

Proposed § 19.00(b)(2) sets forth instructions, which are consistent with the provisions in the current section, for reporting a cash position in a commodity that is different from the commodity underlying the futures contract used for hedging.[510] A person who is unsure of whether a commodity may serve as the basis of a cross-

[510] Proposed § 19.00(b)(2) would add the term commodity derivative contracts (as defined in proposed § 150.1). The proposed definition of cross-commodity hedge in proposed § 150.1 is discussed <u>above</u>.

commodity hedge should refer to the deliverable commodities listed by the relevant DCM under the terms of a particular core referenced futures contract. Persons who wish to avail themselves of cross-commodity hedges are required to file an appropriate series '04 form.[511]

Under vacated § 151.5(g), traders engaged in hedging commercial activity (or hedging swaps that in turn hedge commercial activity) that did not involve the same quantity or commodity as the quantity or commodity associated with positions in referenced contracts that are used to hedge would have been obligated to submit a description of the conversion methodology each time they cross-hedged.[512] In lieu of that, the Commission proposes to instead maintain the special call status concerning such information as set forth in current § 19.00(b)(3).[513] Furthermore, since proposed § 19.00(b)(3) would maintain the requirement that cross-hedged positions be shown both in terms of the equivalent amount of the commodity underlying the commodity derivative contract used for hedging and in terms of the actual cash commodity (as provided for on the appropriate series '04 form), the Commission will be able to determine the hedge ratio used merely by comparing the reported positions. Thus, the Commission will be positioned to review whether a hedge ratio appears reasonable in comparison to, for example, other similarly situated traders, without requiring reporting of the conversion methodology.

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[511] Vacated § 151.5(g) would have required the filing of a Form 404, 404A, or 404S by persons availing themselves of cross-commodity hedges.

[512] See 76 FR at 71692.

[513] See discussion below.

3) Standards and conversion factors

Proposed § 19.00(b)(3) maintains the requirement that standards and conversion factors used in computing cash positions for reporting purposes must be made available to the Commission upon request. Proposed § 19.00(b)(3) would clarify that such information would include hedge ratios used to convert the actual cash commodity to the equivalent amount of the commodity underlying the commodity derivative contract used for hedging, and an explanation of the methodology used for determining the hedge ratio.

4) Examples of completed '04 forms

To assist filers in completing Forms 204, 304, 504, 604 and 704, illustrative examples are provided in appendix A to part 19, adjacent to the blank forms and instructions. Once finalized, filers would be able to contact Commission staff in the Office of Data and Technology (ODT) and/or surveillance staff in the Division of Market Oversight for additional guidance.

d. Information required and timing

Proposed § 19.01(b)(3) would require series '04 reports to be transmitted using the format, coding structure, and electronic data transmission procedures approved in writing by the Commission or its designee.[514]

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[514] For example, the Commission is considering requiring that series '04 reports should be sent to the Commission via FTP, unless otherwise specifically authorized by the Commission or its designee. Prior to submitting series '04 reports, persons would contact the CFTC at (312) 596-0700 to obtain the CFTC trader identification code required by such reports. Further instructions on submitting '04 reports may be found at http://www.cftc.gov/Forms/index.htm. If submission through FTP is impractical, the reporting trader would contact the Commission at (312) 596-0700 for further instruction.

CFTC Form 204 reports with respect to transactions in wheat, corn, oats, soybeans, soybean meal and soybean oil would no longer be sent to the Commission's office in Chicago, IL.

Similarly, CFTC Form 304 reports with respect to transactions in cotton would no longer be sent to the Commission's office in New York, NY.

1) Bona fide hedgers and cotton merchants and dealers

Current § 19.01(a) sets forth the data that must be provided by bona fide hedgers (on Form 204) and by merchants and dealers in cotton (on Form 304).[515] The Commission proposes to continue using Forms 204 and 304, which will feature only minor changes to the types of data to be reported.[516] To accommodate open price pairs, proposed § 19.01(a)(3) would remove the modifier "fixed price" from "fixed price cash position" and would add a specific request for data concerning open price contracts. The Commission would maintain additional reporting requirements for cotton but will incorporate the monthly reporting, including the granularity of equity, certificated and non-certificated cotton stocks, on Form 204. Weekly reporting for cotton will be retained as a separate report made on Form 304 for the collection of data required by the Commission to publish its weekly public cotton "on call" report on www.cftc.gov.

Proposed § 19.01(b) would maintain the requirement that reports on Form 204 be submitted to the Commission on a monthly basis, as of the close of business on the last Friday of the month.[517] Accordingly, commercial firms would measure their respective cash positions on one day a month, as they currently do for Form 204, and submit a

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[515] Vacated § 151.5 would have set forth the application procedure for bona fide hedgers and counterparties to bona fide hedging swap transactions that seek an exemption from the Commission-set Federal position limits for Referenced Contracts. Under vacated § 151.5, had a bona fide hedger sought to claim an exemption from position limits because of cash market activities, then the hedger would have submitted a Form 404 filing pursuant to vacated § 151.5(b). The Form 404 filing would have been submitted when the bona fide hedger exceeded the applicable position limit and claimed an exemption or when its hedging needs increased. Similarly, parties to bona fide hedging swap transactions would have been required to submit a Form 404S filing to qualify for a hedging exemption, which would also have been submitted when the bona fide hedger exceeded the applicable position limit and claimed an exemption or when its hedging needs increased.

[516] The list of data required for persons filing on Forms 204 and 304 would be relocated from current § 19.01(a) to proposed § 19.01(a)(3).

[517] Compare proposed § 19.01(b) with 17 CFR 19.01(b). Additionally, compare proposed § 19.01(b) with vacated § 151.5(c) which would have required that any person holding a derivatives position in excess of a position limit record and ultimately report information about such person's cash positions in the relevant commodity for each day that its derivatives position exceeds the applicable position limit.

monthly report, as currently provided in § 19.01. Proposed § 19.02 provides that Form 304, but not Form 204, must be filed weekly to provide data for the Commission's weekly cotton "on call" report. The Commission would continue to utilize its special call authority in addition to the regular reporting on '04 forms to ensure that it has sufficient information.

2) <u>Conditional spot month limit exemption</u>

Proposed § 19.01(a)(1) would require persons availing themselves of the conditional spot month limit exemption (pursuant to proposed § 150.3(c)) to report certain detailed information concerning their cash market activities for any commodity specially designated by the Commission for reporting under § 19.03 of this part. While traders who avail themselves of this exemption could not directly influence particular settlement prices by trading in the physical-delivery referenced contract, the Commission remains concerned about such traders' activities in the underlying cash commodity. Accordingly, proposed § 19.01(b) would require that persons claiming a conditional spot month limit exemption must report on new Form 504 daily, by 9 a.m. Eastern Time on the next business day, for each day that a person is over the spot month limit in certain special commodity contracts specified by the Commission.[518] The scope of reporting — purchase and sales contracts through the delivery area for the core referenced futures contract and inventory in the delivery area — differs from the scope of reporting for bona fide hedgers, since the person relying on the conditional spot month limit exemption may not be hedging any position.

[518] Additionally, data under this provision may be required by way of special call, in addition to special commodity reporting.

Initially, the Commission would require reporting on new Form 504 for conditional spot month limit exemptions in the natural gas commodity derivative contracts only. Based on its experience in surveillance of natural gas commodity derivative contracts, the Commission believes that enhanced reporting is warranted.[519] The Commission would wait to impose similar reporting requirements for persons claiming conditional spot month limit exemptions in other commodity derivative contracts until the Commission gains additional experience with the limits in proposed § 150.2. In this regard, the Commission will closely monitor the reporting associated with conditional spot month limit exemptions in natural gas and may require reporting on Form 504 for other commodity derivative contracts in the future in response to market developments and to facilitate surveillance.[520]

3) Pass-through swap exemption

Under the definition of bona fide hedging position in proposed § 150.1, a person who uses a swap to reduce risks attendant to a position that qualifies as a bona fide hedging position may pass-through those bona fides to the counterparty, even if the person's swap position is not in excess of a position limit.[521] As such, positions in commodity derivative contracts that reduce the risk of pass-through swaps would qualify as bona fide hedging positions.

Proposed § 19.01(a)(2) would require a person relying on the pass-through swap exemption who holds either of two position types to file a report with the Commission on

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[519] The Commission has observed dramatic instances of disruptive trading practices in the natural gas markets. See United States CFTC v. Amaranth Advisors, LLC, 2009 U.S. Dist. LEXIS 101406 (S.D.N.Y. Aug. 12, 2009). The Commission endeavors to balance the cost of similar enhanced reporting for the other 27 commodities against its experience with observing disruptive trading practices.

[520] See proposed § 19.03.

[521] See supra discussion of the proposed definition of bona fide hedging position.

new Form 604. The first type of position is a swap executed opposite a bona fide hedger that is not a referenced contract and for which the risk is offset with referenced contracts. The second type of position is a cash-settled swap executed opposite a bona fide hedger that is offset with physical-delivery referenced contracts held into a spot month, or, vice versa, a physical-delivery swap executed opposite a bona fide hedger that is offset with cash-settled referenced contracts held into a spot month.

These reports on Form 604 would explain hedgers' needs for large referenced contract positions and would give the Commission the ability to verify the positions were a bona fide hedge, with heightened daily surveillance of spot month offsets. Persons holding any type of pass-through swap position other than the two described above would report on Form 204.[522]

A) Non-referenced contract swap offset

Proposed § 19.01(a)(2)(i) lists the types of data that a person who executes a pass-through swap that is not a referenced contract and for which the risk is offset with referenced contracts must report on new Form 604. Such data requirements include details concerning the non-referenced contract in terms of commodity reference price,[523] notional quantity, gross long or short position in terms of futures-equivalents in the core referenced futures contract, and gross long or short position in the referenced contract used to offset risk.[524] Under proposed § 19.01(b), persons holding a non-referenced

[522] Persons holding pass-through swap positions that are offset with referenced contracts outside the spot month (whether such contracts are for physical delivery or are cash-settled) need not report on Form 604 because swap positions will be netted with referenced contract positions outside the spot month pursuant to proposed § 150.2(b).

[523] As defined in 17 CFR 20.1, a commodity reference price is the price series used by the parties to a swap or swaption to determine payments made, exchanged, or accrued under the terms of that swap or swaption."

[524] In contrast to vacated § 151.5(f) and (g), proposed § 19.01(a)(2)(i) would not require the person to submit a description of the conversion methodology each time he or she cross-hedged.

contract swap offset would submit reports to the Commission on a monthly basis, as of the close of business of the last Friday of the month. This data collection would permit staff to identify offsets of non-referenced-contract pass-through swaps on an ongoing basis for further analysis. The Commission believes collection of this data will be less burdensome on reporting entities than complying with special calls.

B) Spot month swap offset

Under proposed § 150.2(a), a trader in the spot month may not net across physical-delivery and cash-settled contracts for the purpose of complying with federal position limits.[525] If a person executes a cash-settled pass-through swap that is offset with physical-delivery contracts held into a spot month (or vice versa), then, pursuant to proposed § 19.01(a)(2)(ii), that person must report additional information concerning the swap and offsetting referenced contract position on new Form 604. A person need not file a Form 604 if he or she executes a cash-settled pass-through swap that is offset with cash-settled referenced contracts, or, vice versa, a physical delivery pass-through swap offset with physical delivery referenced contracts.[526] Pursuant to proposed § 19.01(b), a person holding a spot month swap offset would need to file on Form 604 as of the close of business on each day during a spot month, and not later than 9 a.m. Eastern Time on the next business day following the date of the report. The Commission notes that pass-through swap offsets would not be permitted during the lesser of the last five days of trading or the time period for the spot month. However, the Commission remains concerned that a trader could hold an extraordinarily large position early in the spot

[525] See supra discussion of proposed § 150.2(a).

[526] To provide clarity in filings, a person may report cash-settled referenced contracts used for bona fide hedging in a separate filing from physical-delivery referenced contracts used for bona fide hedging.

month in the physical-delivery contract along with an offsetting short position in a cash-settled contract, which may disrupt the price discovery function of the underlying physical delivery core referenced futures contract. Hence, the Commission proposes to introduce this new daily reporting requirement within the spot month to identify and monitor such offsetting positions.

5. Section 150.7 — Reporting requirements for anticipatory hedging positions

For reasons discussed above, the revised definition of bona fide hedging in proposed § 150.1 incorporates hedges of five specific types of anticipated transactions: unfilled anticipated requirements, unsold anticipated production, anticipated royalties, anticipated services contract payments or receipts, and anticipatory cross-hedges.[527] The Commission proposes reporting requirements in new § 150.7 for traders seeking an exemption from position limits for any of these five enumerated anticipated hedging transactions. Proposed § 150.7 would build on, and replace, the special reporting requirements for hedging of unsold anticipated production and unfilled anticipated requirements in current § 1.48.[528]

i. Current § 1.48

Current § 1.48 provides a procedure for persons to file for bona fide hedging exemptions for anticipated production or unfilled requirements when that person has not covered the anticipatory need with fixed-price commitments to sell a commodity, or inventory or fixed-price commitments to purchase a commodity. The Commission has long been concerned that distinguishing between what is the reduction of risk arising

[527] See paragraphs (3(iii), (4(i), (iii), and (iv), and (5), respectively, of the Commission's amended definition of bona fide hedging transactions in proposed § 150.1 as discussed above.

[528] See 17 CFR 1.48. See also definition of bona fide hedging transactions in current 17 CFR 1.3(z)(2)(i)(B) and (ii)(C), respectively.

from anticipatory needs, and what is speculation, may be exceedingly difficult if anticipatory transactions are not well defined. Therefore, for more than fifty years, the position limit rules have set discrete reporting requirements in § 1.48 for persons wishing to avail themselves of certain anticipatory bona fide hedging position exemptions.[529] When first promulgated in 1956, § 1.48 set forth reporting requirements for persons hedging anticipated requirements for processing or manufacturing.[530] In 1977, § 1.48 was amended to include similar reporting requirements for a second type of anticipatory hedge transaction: unsold anticipated production.[531] Thereafter, the Commission did not substantively amend § 1.48 until it adopted a new position limits regime in 2011.[532]

In January 2011, the Commission published a notice of proposed rulemaking to replace existing part 150, in its entirety, with a new federal position limits rules regime in the form of new part 151.[533] Proposed § 151.5 would have established exemptions from position limits for bona fide hedging transactions or positions in exempt and agricultural commodities.[534] The referenced contracts subject to the proposed position limit framework would have been subject to the bona fide hedge provisions of proposed §

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[529] See Hedging Anticipated Requirements for Processing or Manufacturing under Section 4a(3) of the Commodity Exchange Act, 21 FR 6913, Sep. 12, 1956.

[530] Id. The statutory definition also provided an anticipatory production hedge for twelve months agricultural production. 7 U.S.C. 6a(3)(A) (1940) (1970). The statutory definition was deleted in 1974, as discussed above in the definition of bona fide hedging position.

[531] See Definition of Bona Fide Hedging Requirements and Related Reporting Requirements, 42 FR 42748, Aug. 24, 1977. The Commission stated at that time that this amended reporting requirement was intended to conform § 1.48 to the updated definition of bona fide hedging in § 1.3(z), and to limit the potential for market disruption. Id. at 42750.

[532] See generally 76 FR 71626, November 18, 2011. Prior to compliance dates, the rule was vacated, as discussed below.

[533] Proposed Rule, 76 FR 4752, Jan. 26, 2011. The final rulemaking for new Part 151 required DCMs to comply with Part 150 until such time that the Commission replaces Part 150 with the new Part 151. See 76 FR 71632.

[534] 76 FR 71643.

151.5 and would have no longer been subject to the definition of bona fide hedging transactions in § 1.3(z), which would have been retained only for excluded commodities.[535] Proposed § 151.5(c) specified reporting and approval requirements for traders seeking an anticipatory hedge exemption, incorporating the current requirements of § 1.48 (and thereby rendering § 1.48 duplicative).[536] However, in an Order dated September 28, 2012, the United States District Court for the District of Columbia vacated part 151.[537] The District Court decision had the effect of reinstating §§ 1.3(z) and 1.48.[538] Therefore, §§ 1.3(z) and 1.48 continue to apply as if part 151 had not been finally adopted by the Commission.

ii. Proposed § 150.7

a. Reporting requirements for anticipatory hedging positions

The Commission's revised definition of bona fide hedging in proposed § 150.1 would enumerate two new types of anticipatory bona hedging positions. Two existing types of anticipatory hedges would be carried forward from the existing definition of bona fide hedging in current § 1.3(z): hedges of unfilled anticipated requirements and hedges of unsold anticipated production, as well as anticipatory cross-commodity hedges of such requirements or production.[539] Proposed § 150.1 would expand the list of enumerated anticipatory bona fide hedging positions to include hedges of anticipated

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[535] 76 FR 71644.

[536] Id. This rulemaking would have removed and reserved § 1.48.

[537] See 887 F. Supp. 2d 259 (D.D.C. 2012).

[538] See Georgetown Univ. Hosp. v. Bowen, 821 F.2d 750, 757 (D.C. Cir. 1987) ("This circuit has previously held that the effect of invalidating an agency rule is to 'reinstate the rules previously in force.'").

[539] See current definition of bona fide hedging transactions at 17 CFR 1.3(z)(2)(i)(B) and (ii)(C), respectively. Cross-commodity hedges are permitted under 17 CFR 1.3(z)(2)(iv). Compare with paragraphs (3)(iii) and (4)(i), respectively, of the definition of bona fide hedging positions in proposed § 150.1, discussed above.

royalties and hedges of anticipated services contract payments or receipts, as well as anticipatory cross-commodity hedges of such contracts.[540] As discussed above, § 1.48 has long required special reporting for hedges of unfilled anticipated requirements and hedges of unsold anticipated production because the Commission remains concerned about distinguishing between anticipatory reduction of risk and speculation. Such concerns apply equally to any position undertaken to reduce the risk of anticipated transactions. Hence, the Commission proposes to extend the special reporting requirements in proposed § 150.7 for all types of enumerated anticipatory hedges that appear in the definition of bona fide hedging positions in proposed § 150.1.

For purposes of simplicity, the proposed special reporting requirements for anticipatory hedges would be placed within the Commission's position limits regime in part 150, and alongside the Commission's updated definition of bona fide hedging positions in proposed § 150.1. Thus, the Commission is proposing to delete the reporting requirements for anticipatory hedges in current § 1.48 because that section is duplicative.

b. New Form 704

The Commission proposes to add a new series '04 reporting form, Form 704, to effectuate these additional and updated reporting requirements for anticipatory hedges. Persons wishing to avail themselves of an exemption for any of the anticipatory hedging transactions enumerated in the updated definition of bona fide hedging in proposed § 150.1 would be required to file an initial statement on Form 704 with the Commission at least ten days in advance of the date that such positions would be in excess of limits established in proposed § 150.2. Advance notice of a trader's intended maximum

[540] See sections (4)(iii) and (iv) and (5), respectively, of the definition of bona fide hedging positions in proposed § 150.1, discussed above.

position in commodity derivative contracts to offset anticipatory risks would allow the Commission to review a proposed position before a trader exceeds the position limits and, thereby, would allow the Commission to prevent excessive speculation in the event that a trader were to misconstrue the purpose of these limited exemptions.[541] The trader's initial statement on Form 704 would provide a detailed description of the person's anticipated activity (i.e., unfilled anticipated requirements, unsold anticipated production, etc.).[542] Under proposed § 150.7(b), the Commission may reject all or a portion of the position as not meeting the requirements for bona fide hedging positions under proposed § 150.1. To support this determination, proposed § 150.7(c) would allow the Commission to request additional specific information concerning the anticipated transaction to be hedged. Otherwise, Form 704 filings that conform to the requirements set forth in proposed § 150.7 would become effective ten days after submission. Proposed § 150.7(e) would require an anticipatory hedger to file a supplemental report on Form 704 whenever the anticipatory hedging needs increase beyond that in its most recent filing.

c. <u>Annual and monthly reporting requirements</u>

Proposed § 150.7(f) would add a requirement for any person who files an initial statement on Form 704 to provide annual updates that detail the person's actual cash market activities related to the anticipated exemption. With an eye towards distinguishing bona fide hedging of anticipatory risks from speculation, annual reporting

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[541] Further, advance filing may serve to reduce the burden on a person who exceeds position limits and who may then otherwise be issued a special call to determine whether the underlying requirements for the exemption have been met. If the Commission were to reject such an exemption, such a person would have already violated position limits.

[542] Proposed 150.7(d)(2) would require additional information for cross hedges, for reasons discussed above.

of actual cash market activities and estimates of remaining unused anticipated exemptions beyond the past year would enable the Commission to verify whether the person's anticipated cash market transactions closely track that person's real cash market activities. Proposed § 150.7(g) would similarly enable the Commission to review and compare the actual cash activities and the remaining unused anticipated hedge transactions by requiring monthly reporting on Form 204. Absent monthly filing, the Commission would need to issue a special call to determine why a person's commodity derivative contract position is, for example, larger than the pro rata balance of her annually reported anticipated production.

As is the case under current § 1.48, proposed § 150.7(h) requires that a trader's maximum sales and purchases must not exceed the lesser of the approved exemption amount or the trader's current actual anticipated transaction.

d. Delegation

The Commission is proposing to delete current § 140.97, which delegates to the Director of the Division of Market Oversight or his designee authority regarding requests for classification of positions as bona fide hedging under current §§ 1.47 and 1.48. For purposes of simplicity, this delegation of authority would be placed in proposed § 150.7(j), within the Commission's position limits regime in part 150.

6. Miscellaneous regulatory amendments

i. Proposed § 150.6 — Ongoing application of the Act and Commission regulations

The Commission is proposing to amend existing § 150.6 to conform the provision with the general applicability of part 150 to SEFs that are trading facilities, and concurrently making non-substantive changes to clarify the provision. The provision, as amended and clarified, provides this part shall only be construed as having an effect on

position limits and that nothing in part150 shall affect any provision promulgated under the Act or Commission regulations including but not limited to those relating to manipulation, attempted manipulation, corners, squeezes, fraudulent or deceptive conduct, or prohibited transactions.[543] For example, by requiring DCMs and SEFs that are trading facilities to impose and enforce exchange-set speculative position limits, the Commission does not intend for the fulfillment of such requirements alone to satisfy any other legal obligations under the Act and Commission regulations of DCMs and SEFs that are trading facilities to detect and deter market manipulation and corners. In another example, a market participant's compliance with position limits or an exemption does not confer any type of safe harbor or good faith defense to a claim that he had engaged in an attempted manipulation, a perfected manipulation or deceptive conduct.

ii. Proposed § 150.8 — Severability

The Commission is proposing to add § 150.8 to address the severability of individual provisions of part 150. Should any provision(s) of part 150 be declared invalid, including the application thereof to any person or circumstance, § 150.8 provides that all remaining provisions of part 150 shall not be affected to the extent that such remaining provisions, or the application thereof, can be given effect without the invalid provisions.[544] The Commission believes it is prudent to include a severability clause to avoid any further delay, as practicable, in carrying out Congress' mandate to impose position limits in a timely manner.

[543] The Commission notes that amended § 150.6 matches vacated § 151.11(h).

[544] The Commission notes that proposed § 150.8 matches vacated § 151.13.

iii. Part 15 — Reports — General provisions

The Commission is proposing to amend the definition of the term "reportable position" in current § 15.00(p)(2) by clarifying that: (1) such positions include swaps; (2) issued and stopped positions are not included in open interest against a position limit; and (3) special calls may be made for any day a person exceeds a limit. Additionally, the Commission is proposing to amend § 15.01(d) by adding language to reference swaps positions. Lastly, the Commission is proposing to amend the list of reporting forms in current § 15.02 to account for new and updated series '04 reporting forms, as discussed above.[545]

iv. Part 17 — Reports by reporting markets, futures commission merchants, clearing members, and foreign brokers

The Commission is proposing to amend current § 17.00(b) to delete aggregation provisions, since those provisions are duplicative of aggregation provisions in § 150.4.[546] Proposed § 17.00(b) would provide that "[e]xcept as otherwise instructed by the Commission or its designee and as specifically provided in § 150.4 of this chapter, if any person holds or has a financial interest in or controls more than one account, all such accounts shall be considered by the futures commission merchant, clearing member or foreign broker as a single account for the purpose of determining special account status and for reporting purposes." In addition, proposed § 17.03(h) would delegate to the

[545] See discussion of new and amended series '04 reports above.

[546] In a separate proposal approved on the same date as this proposal, the Commission is proposing amendments to § 150.4 — aggregation of positions. See Aggregation NPRM (Nov. 5, 2013).

Director of the Division of Market Oversight or his designee the authority to instruct persons pursuant to proposed § 17.03.[547]

II. Revision of Rules, Guidance, and Acceptable Practices Applicable to Exchange-Set Speculative Position Limits — § 150.5

A. Background

Pursuant to 17 CFR part 150, the Commission administers speculative position limits on futures contracts for certain agricultural commodities.[548] Prior to the CEA's amendment in 1974, which expanded its jurisdiction to all "services, rights and interests" in which futures contracts are traded, only certain designated agricultural commodities could be regulated. Both prior to and after the 1974 amendments to the Act, futures markets that traded commodities not so enumerated applied speculative position limits by exchange rule, if at all. In 1981, the Commission promulgated § 1.61, which required that, absent an exemption, exchanges must adopt and enforce speculative position limits for all contracts that are not subject to the Commission-set limits.[549] The Commission has periodically reviewed and updated its policies and rules pertaining to each of the three basic elements of the regulatory framework for speculative position limits, namely,

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[547] In a separate final rulemaking (Oct. 30, 2013), the Commission adopted amendments to § 17.03; the current proposal would amend § 17.03 further by adding proposed § 17.03(h).

[548] See 17 CFR Part 150.

[549] See Establishment of Speculative Position Limits, 46 FR 50938, Oct. 16, 1981, and 17 CFR 1.61 (removed and reserved May 5, 1999). Section 1.61 permitted exchanges to adopt and enforce their own speculative position limits for those contracts that were covered by Commission-set speculative position limits, as long as the exchange limits were not higher than those set by the Commission. Furthermore, CEA section 4a(e) provides that a violation of a speculative position limit established by a Commission-approved exchange rule is also a violation of the Act. Thus, the Commission can enforce directly violations of exchange-set speculative position limits as well as those provided under Commission rules.

the levels of the limits, the exemptions from them (in particular, for hedgers), and the policy on aggregating accounts.[550]

In 1999, the Commission relocated several of the rules and policies concerning exchange-set-position limits from § 1.61 to current § 150.5, thereby incorporating within part 150 most Commission rules relating to speculative position limits. The Commission codified as rules within § 150.5 various staff policies and administrative practices that had developed over time. These policies and practices related to the speculative position limit levels that the staff had routinely recommended for approval by the Commission for newly designated futures and option contracts, as well as the magnitude of increases to the limit levels that it would approve for already-traded contracts. The Commission also codified within § 150.5 various exemptions from the general requirement that exchanges must set speculative position limits for all contracts. The exemptions included permitting exchanges to substitute position accountability rules for position limits for physical commodity derivatives outside the spot month in high volume and liquid markets.[551]

Less than two years after the Commission promulgated § 150.5, the Commodity Futures Modernization Act of 2000 ("CFMA")[552] amended the CEA to include a set of

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[550] Initially, for example, the Commission redefined "hedging" (see 42 FR 42748, Aug. 24, 1977), and raised speculative position limits in wheat (see 41 FR 35060, Aug. 19, 1976). Subsequently, for example, the Commission solicited public comment on, and subsequently approved, exchange requests for exemptions for futures and option contracts on certain financial instruments from the requirement specified by former § 1.61 that speculative position limits be specified for all contracts. See 56 FR 51687, Oct. 15, 1991.

[551] See 17 CFR 150.5. See also Revision of Federal Speculative Position Limits and Associated Rules, Final Rules, 64 FR 24038, 24040-42, May 5, 1999. As noted in the notice of proposed rulemaking for §150.5, promulgating these policies within a single section of the Commission's rules would increase significantly their accessibility and clarify their terms. See 63 FR 38537, Jul. 17, 1998.

[552] Commodity Futures Modernization Act of 2000, Public Law 106-554, 114 Stat. 2763 (Dec. 21, 2000). By enacting the CFMA, Congress intended "[t]o reauthorize and amend the Commodity Exchange Act to promote legal certainty, enhance competition, and reduce systemic risk in markets for futures and over-the-counter derivatives …." Id.

core principles that DCMs must comply with at the time of application, and on an ongoing basis after designation,[553] including DCM core principle 5, which requires exchanges to adopt position limits or position accountability levels where necessary and appropriate to reduce the threat of market manipulation or congestion.[554] The CFMA further amended the CEA to provide DCMs with "reasonable discretion" in determining how to comply with each core principle, including core principle 5 regarding exchange-set position limits.[555] Since 2000, the Commission has continued to maintain § 150.5, but only as guidance on, and acceptable practices for, compliance with DCM core principle 5. The Commission did not amend § 150.5 following passage of the CFMA.

In 2010, the Dodd-Frank Act amended the CEA to explicitly provide that the Commission may mandate the manner in which DCMs must comply with the core principles.[556] Specifically, the Dodd-Frank Act amended DCM core principle 1 to include the condition that "[u]nless otherwise determined by the Commission by rule or regulation," boards of trade shall have reasonable discretion in establishing the manner in which they comply with the core principles.[557]

Additionally, the Dodd-Frank Act amended DCM core principle 5 to require that, for any contract that is subject to a position limitation established by the Commission

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[553] See CEA section 5(d); 7 U.S.C. 7(d). The CEA, as amended by the CFMA, required a DCM applicant to demonstrate its ability to comply with 18 core principles.

[554] CEA section 5(d)(5); 7 U.S.C. 7(d)(5).

[555] DCM core principle 1 states, among other things, that boards of trade "shall have reasonable discretion in establishing the manner in which they comply with the core principles." This "reasonable discretion" provision underpinned the Commission's use of core principle guidance and acceptable practices. See former CEA section 5(d)(1)(amended in 2010); U.S.C. 7(d)(1). As discussed above, the Dodd-Frank Act subsequently amended DCM core principle 1 to specifically provide the Commission with discretion to determine, by rule or regulation, the manner in which boards of trade comply with the core principles.

[556] See CEA section 5(d)(1)(B); 7 U.S.C. 7(d)(1)(B).

[557] See id. Congress limited the exercise of reasonable discretion by DCMs only where the Commission has acted by regulation.

pursuant to CEA section 4a(a), the DCM "shall set the position limitation of the board of trade at a level not higher than the position limitation established by the Commission."[558] Furthermore, the Dodd-Frank Act added CEA section 5h to provide a regulatory framework for Commission oversight of SEFs.[559] Under SEF core principle 6, which parallels DCM core principle 5, Congress required that SEFs adopt for each swap, as is necessary and appropriate, position limits or position accountability.[560] In addition, Congress required that, for any contract that is subject to a Federal position limit under CEA Section 4a(a), the SEF shall set its position limits at a level no higher than the position limitation established by the Commission.[561]

In view of these Dodd-Frank Act amendments, the Commission proposes several amendments to update and streamline the part 150 regulations. First, the Commission proposes new and amended clarifying definitions in § 150.1 that relate particularly to position limits. Second, the Commission proposes to amend § 150.5 to include SEFs and swaps. Third, the Commission proposes to codify rules and acceptable practices for compliance with DCM core principle 5 and SEF core principle 6 within amended § 150.5(a) for commodity derivative contracts that are subject to the federal position limits set forth in § 150.2. Lastly, the Commission proposes to codify rules and revise guidance and acceptable practices for compliance with DCM core principle 5 and SEF core principle 6 within amended § 150.5(b) for commodity derivative contracts that are not subject to the Federal position limits set forth in § 150.2.

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[558] See CEA section 5(d)(5)(B) (amended 2010); 7 U.S.C. 7(d)(5)(B).

[559] See CEA section 5h; 7 U.S.C. 7b-3.

[560] CEA section 5h(f)(6); 7 U.S.C. 7b-3(f)(6).

[561] Id.

B. The Current Regulatory Framework for Exchange-Set Position Limits

1. Section 150.5

The Commission currently sets and enforces position limits pursuant to its broad authority under CEA section 4a[562] and does so only with respect to certain enumerated agricultural products.[563] In 1981, the Commission promulgated what was then 17 CFR 1.61 (re-codified in 1999 as 17 CFR 150.5), which required that, absent an exemption, exchanges must adopt and enforce speculative position limits for all futures contracts that were not subject to Commission-set limits.[564]

The Commission's 1981 rule requiring that exchanges set position limits was a watershed in its approach to position limits. The Commission first concluded that multiple provisions of the CEA vested it with authority to direct that exchanges impose position limits.[565] The Commission explained that section 4a "represents an express Congressional finding that excessive speculation is harmful to the market, and a finding that speculative limits are an effective prophylactic measure."[566] Relying on those

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[562] CEA section 4a, as amended by the Dodd-Frank Act, provides the Commission with broad authority to set position limits. 7 U.S.C. 6a. See supra discussion of CEA section 4a.

[563] The position limits on these agricultural contracts are referred to as "legacy" limits, and the listed commodities are referred to as the "enumerated" agricultural commodities. This list of agricultural contracts includes Corn (and Mini-Corn), Oats, Soybeans (and Mini-Soybeans), Wheat (and Mini-wheat), Soybean Oil, Soybean Meal, Hard Red Spring Wheat, Hard Winter Wheat, and Cotton No. 2. See 17 CFR 150.2.

[564] 46 FR 50938, Oct. 16, 1981. The Commission stated the purpose of such limits was to prevent "excessive speculation … arising from those extraordinarily large positions which may cause sudden or unreasonable fluctuations or unwarranted changes in the price" of commodity futures. Id. at 50945. Former § 1.61(a)(2) specified that limits shall be based on "such factors that will accomplish the purposes of this section. As appropriate, these factors shall include position sizes customarily held by speculative traders in the market …, which shall not be extraordinarily large relative to total open positions in the contract market … [or] breadth and liquidity of the cash market underlying each delivery month and the opportunity for arbitrage between the futures market and cash market in the commodity underlying the futures contract." 17 CFR 1.61 (removed and reserved on May 5, 1999).

[565] 46 FR 50938, 50939-40, Oct. 16, 1981.

[566] Id. at 50940.

Congressional findings, the Commission directed exchanges to impose speculative position limits on all futures contracts subject to their jurisdiction.[567]

In adopting this prophylactic approach, the Commission explained that comments it had received during the rulemaking that questioned "the general desirability of [position] limits [were] contrary to Congressional findings in sections 3 and 4a of the Act and considerable years of Federal and contract market regulatory experience."[568] The Commission also explained that:

> the prevention of large and/or abrupt price movements which are attributable to extraordinarily large speculative positions is a Congressionally endorsed regulatory objective of the Commission. Further ... 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 the positions, i.e., the capacity of the market is not unlimited.[569]

Citing the recent disruption in the silver market, the Commission insisted that position limits be imposed prophylactically for all futures and options contracts, irrespective of the unique features of the cash market underlying a particular derivative.[570] Thus, the Commission concluded that "speculative limits are appropriate for all contract markets,"[571] and directed exchanges to impose them on an "omnibus basis,"[572] that is, on all futures contracts.[573]

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[567] Id. at 50945.

[568] Id. at 50940.

[569] Id.

[570] Id. at 50940-41. The Commission stated it would consider the particular characteristics of the cash markets in setting limit levels, but required that all futures contracts have position limits. Id. at 50941.

[571] Id. at 50941.

[572] Id. at 50939.

[573] See 17 CFR 1.61(a)(1) (1982). In addition, § 1.61 permitted exchanges to adopt and enforce their own speculative position limits for those contracts that have federal speculative position limits, as long as the exchange limits were not higher than those set by the Commission.

Congress ratified the Commission's construction of section 4a and its promulgation of § 1.61 in the Futures Trading Act of 1982[574] when it enacted section 4a(e) of the Act, which provides that limits set by exchanges and approved by the Commission are subject to Commission enforcement.[575]

During the 1990s, the Commission allowed exchanges to replace position limits with position accountability levels with respect to certain derivatives outside the spot month.[576] Position accountability levels are not fixed limits, but rather position sizes that trigger an exchange review of a trader's position and at which an exchange may remediate perceived problems, such as preventing a trader from increasing his position or forcing a reduction in a position. In January 1992, the Commission approved the CME's request for an exemption from the position limits requirements and permitted the CME to establish position accountability for a variety of financial contracts. Initially, the Commission limited its approval of position accountability to financial instruments (i.e., excluded commodities) that had a high degree of liquidity. Six months later, the Commission determined it would also allow position accountability to be used for highly liquid energy and metals contracts.[577]

In 1999, the Commission simplified and reorganized its rules relating to speculative position limits by removing and reserving § 1.61 and relocating several of its rules and policies concerning exchange-set-position limits to new § 150.5, thereby incorporating within part 150 most Commission rules relating to speculative position

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[574] The Futures Trading Act of 1982, Public Law P.L. 97-444, 96 Stat. 2294 (1983).

[575] See id; see also 7 U.S.C. 6a(e).

[576] See Speculative Position Limits — Exemptions from Commission Rule 1.61, 56 FR 51687, Oct. 15, 1991; and Speculative Position Limits — Exemptions from Commission Rule 1.61, 57 FR 29064, Jun. 30, 1992.

[577] See 57 FR 29064, Jun. 30, 1992.

limits.[578] The Commission codified within § 150.5 various staff policies and administrative practices that had developed over time relating to: (1) the speculative position limit levels that the staff routinely had recommended for approval by the Commission for newly designated futures and option contracts; (2) the magnitude of increases to the limit levels that it would approve for traded contracts; and (3) various exemptions from the general requirement that exchanges set speculative position limits for all contracts, such as permitting exchanges to substitute position accountability rules for position limits for high volume and liquid markets.[579] The Commission explained that codifying the prior administrative practices as part of new § 150.5 would make the applicable standard for exchange-set position limits more transparent and thereby make compliance easier for exchanges to achieve.[580]

Under § 150.5(a), the Commission required each exchange to "limit the maximum number of contracts a person may hold or control, separately or in combination, net long or net short, for the purchase or sale of a commodity for future delivery or, on a futures-equivalent basis, options thereon."[581] The Commission noted that this provision does not

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[578] 64 FR 24038, 24040, May 5, 1999. As noted in the notice of proposed rulemaking for §150.5, promulgating these policies within a single section of the Commission's rules would increase significantly their accessibility and clarify their terms. See Revision of Federal Speculative Position Limits and Associated Rules, Proposed Rules, 63 FR 38537, Jul. 17, 1998.

[579] 64 FR at 24040-42. As the Commission explained, the open-interest criterion and numeric formula used by the Commission in its 1991 proposed amendment of Commission-set speculative position limits provided the most definitive guidance by the Commission on acceptable levels for speculative position limits for tangible commodities and, along with several other commonly accepted measures, had been widely followed as a matter of administrative practice when reviewing proposed exchange speculative position limits under Commission rule 1.61. Id. at 24040. Additionally, in reviewing new contracts for tangible commodities, the staff had relied upon the Commission's formulation providing for a minimum level of 1,000 contracts for non-spot month speculative position limits. Id. Moreover, the Commission had routinely approved a level of 5,000 contracts in non-spot months for designation of financial futures and energy contracts, and that level had become a rule of thumb as a matter of administrative practice. Id.

[580] Id.

[581] 17 CFR 150.5(a).

apply to contracts for which position limits are set forth in § 150.2 or to a futures or option contract on a major foreign currency.[582] Furthermore, nothing in § 150.5(a) was to be construed to prohibit an exchange from setting different limits for different futures contracts or delivery months, or from exempting positions normally known in the trade as spreads, straddles, or arbitrage.[583]

In § 150.5(b), the Commission presented explicit numeric formulas and descriptive standards for the speculative position limit levels that it found to be appropriate for new contracts.[584] For physical delivery contracts, the spot month limit level must be no greater than one-quarter of the estimated spot month deliverable supply, calculated separately for each month to be listed.[585] For cash-settled contracts, the Commission presented a descriptive standard: "the spot month limit level must be no greater than necessary to minimize the potential for manipulation or distortion of the contract's or the underlying commodity's price."[586] Individual non-spot-month or all-months-combined levels for such newly-designated contracts must be no greater than 1,000 contracts for tangible commodities other than energy products,[587] and no greater than 5,000 contracts for energy products and non-tangible commodities, including contracts on financial products.[588] In § 150.5(c), the Commission codified mandatory

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[582] Id.

[583] Id.

[584] See 17 CFR 150.5(b). The Commission explained that the proposed limit levels for new contracts, which were based upon the formula and associated minimum levels used by the Commission in its 1992 proposed rulemaking, had long been used as a matter of informal administrative practice. 64 FR 24040.

[585] 17 CFR 150.5(b)(1).

[586] Id.

[587] 17 CFR 150.5(b)(2).

[588] 17 CFR 150.5(b)(3).

numeric formulas and descriptive standards for subsequent adjustments to spot, individual and all-months-combined position limit levels.[589]

The Commission explained that these explicit numeric formulas grew from administrative practices that had long required a deliverable supply of at least four times the spot month speculative position limit.[590] The Commission further explained that that the descriptive standards for exchange-set limits in § 150.5 grew from staff experience that had demonstrated that many commodities, particularly intangible commodities, have sufficiently large deliverable supplies to meet this standard without requiring a spot month level that is lower than the individual month level.[591]

In § 150.5(d), the Commission explicitly precluded exchanges from applying exchange-set speculative position limits rules to bona fide hedging positions as defined by an exchange in accordance with § 1.3(z)(1).[592] However, that section also provided an exchange with the discretion to limit bona fide hedging positions that it determines are "not in accord with sound commercial practices or [that] exceed an amount which may be established and liquidated in an orderly fashion."[593] Under § 150.5(d)(2), the Commission explicitly required traders to apply to the exchange for any exemption from

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[589] 17 CFR 150.5(c).

[590] 64 FR at 24041 (citing 62 FR 60831, 60838, Nov. 13, 1997). A spot month speculative position limit that exceeds this amount enhances the susceptibility of the contract to market manipulation, price distortion or congestion. Except for cash-settled contracts, Commission staff had used this standard to review every new contract, or proposals to increase existing exchange speculative position limits, since 1981, when § 1.61 was issued. Id.

[591] 64 FR at 24041. For other commodities, however, especially commodities having strong seasonal characteristics, spot month speculative position limits are required to be set at a level lower than the individual month limit for all or some trading months. Id. Accordingly, codification of the standard only made explicit the standard which, since 1981, had been applied to, and met by, every physical delivery futures contract at the time of initial review and upon subsequent increases to the spot month speculative position limit. Id.

[592] 17 CFR 150.5(d)(1); 17 CFR 1.3(z).

[593] 17 CFR 150.5(d)(1).

its speculative position limit rules.[594] Furthermore, under § 150.5(f), an exchange is compelled to grant additional exemptions to positions acquired in good faith prior to the effective date of any exchange position limits rule.[595] In addition to the express exemptions specified in § 150.5, § 150.5(f) permitted an exchange to propose other exemptions consistent with the purposes of § 150.5.[596]

In § 150.5(e), the Commission codified its existing policies concerning the classes of contracts for which an exchange could replace the required speculative position limit with a position accountability rule.[597] Under § 150.5(e), at least twelve months after a contract's initial listing for trading, an exchange could apply to the Commission to substitute for the position limits required under part 150 an exchange rule requiring traders to be accountable for large positions.[598] The Commission explained that the type of position accountability rule that applies to a particular contract under § 150.5(e) is determined by the liquidity of the futures market, the liquidity of the cash market and the Commission's oversight experience.[599] The Commission further explained that it used §

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[594] 17 CFR 150.5(d)(2). In considering whether to grant such an application for exemption, exchanges must take into account whether the hedging position is not in accord with sound commercial practices or exceeds an amount which may be established and liquidated in an orderly fashion. See id.

[595] 17 CFR 150.5(f). This exemption also applies to positions acquired in good faith prior to the effective date of any exchange position limits rule by a person that is registered as a futures commission merchant or as a floor broker under authority of the Act except to the extent that transactions made by such person are made for or on behalf of the account or benefit of such person.

[596] Id.

[597] 17 CFR 150.5(e). Position accountability rules impose a level that triggers distinct reporting responsibilities by a trader at the request of the applicable exchange.

[598] Id. The Commission explained that a trading history of at least 12 months must first be established before a futures contract can meet the proposed rule's liquidity requirements. See Proposed Rule, 63 FR 38525, 38529, Jul. 17, 1998.

[599] Revision of Federal Position Limits and Associated Rules, Proposed Rule, 63 FR 38525, 38530, Jul. 17, 1998. The Commission explained that a liquid market is one which has sufficient trading activity to enable individual trades coming to a market to be transacted without significantly affecting the price. Id. A high degree of liquidity in the futures and option markets better enables traders to arbitrage these markets with the underlying cash markets. Id. Where the underlying cash markets in turn are very liquid and have

150.5(e) to restate these criteria with greater clarity and precision, particularly in measuring the necessary levels of liquidity of the futures and option markets.[600] Furthermore, for purposes of § 150.5(e), trading volume and open interest must be calculated by combining the month-end futures and its related option contract, on a delta-adjusted basis, for all months listed during the most recent calendar year.[601]

Lastly, the Commission codified its aggregation policy relating to exchange-set position limits in § 150.5(g).[602]

2. The Commodity Futures Modernization Act of 2000 caused Commission § 150.5 to become guidance on and acceptable practices for compliance with DCM core principle 5

Just over a year after the Commission promulgated § 150.5, the Commodity Futures Modernization Act of 2000[603] amended the CEA to establish DCMs as a registration category and create a set of 18 core principles with which DCMs must comply.[604] DCM core principle 5 requires exchanges to adopt position limits or position

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extremely large deliverable supplies, the threat of market manipulation or distortions caused by large speculative positions is lessened. Id.

[600] See 17 CFR 150.5(e)(1)–(3); see also Proposed Rule, 63 FR 38525, 38530, Jul. 17, 1998.

[601] 17 CFR 150.5(e)(4).

[602] To determine whether any person has exceeded the limits established under this section, all positions in accounts for which such person by power of attorney or otherwise directly or indirectly controls trading shall be included with the positions held by such person; such limits upon positions shall apply to positions held by two or more person acting pursuant to an express or implied agreement or understanding, the same as if the positions were held by a single person. 17 CFR 150.5(g).

[603] CFMA, Public Law 106-554, 114 Stat. 2763. By enacting the CFMA, Congress intended "[t]o reauthorize and amend the Commodity Exchange Act to promote legal certainty, enhance competition, and reduce systemic risk in markets for futures and over-the-counter derivatives, and for other purposes." Id.

[604] See CEA section 5(d); 7 U.S.C. 7(d). DCMs were first established under the CFMA as one of two forms of Commission-regulated markets for the trading of contracts for sale of a commodity for future delivery or commodity options (the other being registered DTEFs). In addition, the CFMA provided for two markets exempt from regulation: exempt boards of trade ("EBOTs") and exempt commercial markets ("ECMs"). See A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing

accountability levels "where necessary and appropriate to reduce the threat of market manipulation or congestion."[605] Under the CFMA, DCM core principle 1 gave DCMs "reasonable discretion" in determining how to comply with the core principles.[606] The CFMA, however, did not change the treatment of the enumerated agricultural commodities, which remain subject to Federal speculative position limits. Moreover, the CFMA did not alter the Commission's authority in CEA section 4a to establish position limits. The core principles regime set forth in the CFMA had the effect of undercutting the prescriptive rules of § 150.5 because DCMs were afforded "reasonable discretion" in determining how to comply with the position limits or accountability requirements of core principle 5. Nevertheless, the Commission has retained current § 150.5 as guidance on, and acceptable practices for, compliance with DCM core principle 5.[607] The Commission did not amend § 150.5 following passage of CFMA.

In August 2001, the Commission adopted part 38 to govern trading on DCMs post-CFMA. Under § 38.2, DCMs operating under part 38 were "exempt from all

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Organizations, Notice of Proposed Rulemaking, 66 FR 14262, Mar. 9, 2001; Final Rulemaking, 66 FR 42256, Aug. 10, 2001.

[605] CEA sections 5(d)(1), (5); 7 U.S.C. 7(d)(1), (5).

[606] CEA section 5(d)(1)(B); 7 U.S.C. 7(d)(1)(B). The Commission also undertakes due diligence reviews of each exchange's compliance with the core principles during rule and product certification reviews and periodic examinations of DCMs' compliance with the core principles under Rule Enforcement Reviews. As discussed above, DCM core principle 1 was amended by the Dodd-Frank Act to give the Commission authority to determine, by rule or regulation, the manner in which boards of trade must comply with the core principles.

[607] Guidance provides DCMs and DCM applicants with contextual information regarding the core principles, including important concerns which the Commission believes should be taken into account in complying with specific core principles. In contrast, the acceptable practices are more specific than guidance and provide examples of how DCMs may satisfy particular requirements of the core principles; they do not, however, establish mandatory means of compliance. Acceptable practices are intended to assist DCMs by establishing non-exclusive safe harbors. The safe harbors apply only to compliance with specific aspects of the core principle, and do not protect the exchange with respect to charges of violations of other sections of the CEA or other aspects of the core principle. In applying § 150.5 as guidance and acceptable practices, most exchanges, in exercising their "reasonable discretion," have continued to impose strict position limits in the spot month and to apply position accountability standards in non-spot months.

Commission rules not specifically reserved"[608] and § 38.2 did not reserve § 150.5.[609] Accordingly, DCMs operating under part 38 in the post-CFMA environment have not been required to comply with § 150.5. In this same rulemaking, the Commission adopted appendix B to part 38 as guidance on and acceptable practices for compliance with the DCM core principles, including core principle 5.[610] Within appendix B to part 38, the Commission advised DCMs to, among other things, adopt spot-month limits 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.[611] The Commission also advised DCMs on how they should set spot-moth limit levels and instructed DCMs that they could elect not to adopt all-months-combined and non-spot month limits.[612] Appendix B to part 38 was subsequently amended in June 2012 to delete the guidance and acceptable practices section relevant to compliance with DCM core principle 5 in deference to parts 150 and 151.[613]

3. The CFTC Reauthorization Act of 2008

In the CFTC Reauthorization Act of 2008, Congress, among other things, expanded the Commission's authority to set position limits to include significant price

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[608] 17 CFR 38.2 (amended June 19, 2012); see also A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations, Final Rules, 66 FR 42256, 42257, Aug. 10, 2001.

[609] See id.

[610] 17 CFR part 38 app. B (2002); see also 66 FR 42256, Aug. 10, 2001.

[611] Id.

[612] Id.

[613] See Core Principles and Other Requirements for Designated Contract Markets, Final Rule, 77 FR 36611, 36639, Jun. 19, 2012. The Commission published the final rules for Position Limits for Futures and Swaps on November 18, 2011, which required DCMs to comply with part 150 (Limits on Positions) until such time that the Commission replaces part 150 with the new part 151 (Limits on Positions). Id.

discovery contracts ("SPDCs") on exempt commercial markets ("ECMs").[614] The Reauthorization Act's provisions regarding ECMs were based largely on the Commission's recommendations for improving oversight of ECMs whose contracts perform or affect a significant price discovery function. The legislation significantly expanded the Commission's regulatory authority over ECMs by adding section 2(h)(7)[615] to the CEA, establishing criteria for the Commission to consider in determining whether a particular ECM contract performs a significant price discovery function, and providing for greater regulation of SPDCs traded on ECMs. The Reauthorization Act also required ECMs to adopt position limit and accountability level provisions for SPDCs, authorized the Commission to require the reporting of large trader positions in SPDCs, and established core principles governing ECMs with SPDCs. The core principles applicable to ECMs with SPDCs were largely derived from selected DCM core principles and designation criteria set forth in CEA section 5, and Congress intended that they be construed in a like manner.[616]

Much like DCM core principle 5, ECM core principle IV of CEA section 2(h)(7)(C) required electronic trading facilities to adopt where necessary and appropriate, position limits or position accountability provisions, especially during trading in the

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[614] CFTC Reauthorization Act of 2008, incorporated as Title XIII of the Food, Conservation and Energy Act of 2008, Public Law 110–246, 122 Stat. 1651 (June 18, 2008).

[615] CEA sections 2(h)(3)-(7) were deleted by the Dodd-Frank Act on July 15, 2011, thus eliminating the ECM category.

[616] See Joint Explanatory Statement of the Committee of Conference, H.R. Rep. No. 110–627, 110 Cong., 2d Sess. at 985 (2008). Section 723 of the Dodd-Frank Act subsequently repealed the ECM SPDC provisions. See Section 723 of the Dodd-Frank Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

delivery month, and taking into account fungible positions at a derivative clearing organization.[617]

In a Notice of Final Rulemaking in March 2009, the Commission adopted Appendix B to Part 36 as guidance on and acceptable practices for compliance with ECM core principles.[618] The guidance on and acceptable practices for compliance with ECM core principle IV generally tracked those for DCM core principle 5 as listed in § 150.5.[619] Furthermore, the Commission indicated within this Notice of Final Rulemaking that § 150.5 was not binding on DCMs once part 38 was finalized.[620] The Commission rejected a commenter's suggestion that a proposed ECM-SPDCs core principle for position limits and accountability should adopt the existing standards in CEA section 4a(b)(2) (barring trading or positions in excess of federal limits) and, especially, incorporate a broader good faith exemption in § 150.5(f).[621] The Commission responded that section 4a(b)(2) applies to federal limits, not exchange-set limits.[622] The Commission further explained that § 150.5(f) "no longer has direct application to DCM-set limits" because "the

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[617] CEA section 2(h)(7)(C) (amended 2010).

[618] Significant Price Discovery Contracts on Exempt Commercial Markets, Final Rulemaking, 74 FR 12178, Mar. 23, 2009; See also 17 CFR part 36 app. B (2009).

[619] For example, ECMs were advised to adopt spot-month limits for SPDCs. If there was an economically-equivalent SPDC, or a contract on a DCM, then the spot-month limit should be set at the same level as that specified for such other contract. If there was not an economically-equivalent SPDC or contract traded on a DCM, then in the case of a physical delivery contact, the spot-month limit should be set based upon an analysis of deliverable supplies and the history of spot-month liquidations and at no more than 25 percent of the estimated deliverable supply or, in the case of a cash settlement provision, the spot month limit should be set at a level that minimizes the potential for price manipulation or distortion in the significant price discovery contract itself; in related futures and options contracts traded on a DCM or DTEF; in other significant price discovery contracts; in other fungible agreements, contracts and transactions; and in the underlying commodity. ECMs were also advised to adopt position accountability provisions for non-spot month and all-months combined or, in lieu of position accountability, an ECM could establish non-spot individual month position limits and all-months-combined position limits for its SPDC. See 17 CFR part 36 app. B (2009).

[620] See 74 FR 12178, 12183, Mar. 23, 2009.

[621] See id.

[622] See id.

statutory authority governing [those] limits is found in CEA section 5(d)(5)---DCM core principle 5."[623] That core principle does not, the Commission explained, contain any of the exemptive language found in CEA section 4a or § 150.5(f).[624] The Commission observed that the part 38 rules specifically exempt DCMs and DCM-traded contracts from all rules other than those specifically reserved in § 38.2, and § 38.2 did not retain § 150.5(f).[625] Accordingly, the Commission explained, "the part 150 rules essentially constitute guidance for DCMs administering position limit regimes, [and] Commission staff in overseeing such regimes has not required that position limits include an exemption for positions acquired in good faith."[626]

4. <u>The Dodd-Frank Act Amendments to CEA section 5</u>

On July 21, 2010, President Obama signed The Dodd-Frank Wall Street Reform and Consumer Protection Act.[627] The legislation was enacted to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things, enhancing the Commission's rulemaking and enforcement authorities with respect to all registered entities and intermediaries subject to the Commission's oversight.[628] The

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[623] <u>See id.</u>

[624] <u>See id;</u> <u>see also</u> CEA Section 4a and 17 CFR 150.5(f).

[625] <u>See</u> 74 FR 12178, 12183, Mar. 23, 2009; <u>see also</u> 17 CFR Part 38. The Commission acknowledged that the acceptable practices in former appendix B to part 38 incorporate many provisions of § 150.5, but not § 150.5(f).

[626] 74 FR 12183. In a 2010 notice of proposed rulemaking, the Commission similarly noted that former appendix B to part 38 "specifically reference[d] part 150" in order to provide "guidance" to DCMs on how to comply with the core principle on position limits/accountability. 75 FR 4144, 4147, Jan. 26, 2010.

[627] <u>See generally</u> the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

[628] Furthermore, the Dodd-Frank Act amended the DCM core principles by: (1) eliminating the eight criteria for designation as a contract market; (2) amending most of the core principles, including incorporating the substantive requirements of the designation criteria; and (3) adding five new core principles. Accordingly, all DCMs and DCM applicants must comply with a total of 23 core principles as a condition of obtaining and maintaining designation as a contract market.

Dodd-Frank Act repealed certain sections of the CEA, amended others, and added many new provisions and vastly expanded the Commission's jurisdiction. The Commission has finalized 65 rules, orders, and guidance to implement sweeping changes to the regulatory framework established by the Dodd-Frank Act.[629] This proposed rulemaking would make several conforming amendments to part 150 of the Commission's regulations, most prominently to § 150.5, in order to integrate that section more fully within the statutory framework created by the Dodd-Frank Act.

i. The Dodd-Frank Act added provisions that permit the Commission to override the discretion of DCMs in determining how to comply with the core principles

As discussed above, DCM core principle 1, set out in CEA section 5(d)(1), states that boards of trade "shall have reasonable discretion in establishing the manner in which they comply with the core principles."[630] However, section 735 of the Dodd-Frank Act amended section 5(d)(1) of the CEA to include the proviso that "[u]nless otherwise determined by the Commission by rule or regulation …," boards of trade shall have reasonable discretion in establishing the manner in which they comply with the core principles.[631] In view of amended CEA section 5(d)(1), which gives the Commission authority to determine, by rule or regulation, the manner in which boards of trade must comply with the core principles, the Commission has proposed a number of new and revised rules, guidance, and acceptable practices to implement the new and revised Dodd-Frank Act core principles.

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[629] 77 FR 66288, Nov. 2, 2012. See also amendments to CEA section 4a, discussed above.

[630] CEA section 5(d)(1); 7 U.S.C. 7(d)(1).

[631] See CEA section 5(d)(1)(B); 7 U.S.C. 7(d)(1)(B).

ii. The Dodd-Frank Act established a comprehensive new statutory framework for swaps

The Dodd-Frank Act tasked the Commission with overseeing the U.S. market for swaps (except for security-based swaps). Title VII of the Dodd-Frank Act amended the CEA to establish a comprehensive new regulatory framework for swaps, including requirements for SEFs.[632] This new regulatory framework includes: (1) registration, operation, and compliance requirements for SEFs; and (2) fifteen core principles with which SEFs must comply. As a condition of obtaining and maintaining their registration as a SEF, applicants and registered SEFs are required to comply with the SEF core principles and with any requirement that the Commission may impose by rule or regulation.[633] The Dodd-Frank Act also amended the CEA to provide that, under new section 5h, the Commission may determine, by rule or regulation, the manner in which SEFs comply with the core principles.[634]

iii. The Dodd-Frank Act added the regulation of swaps, added core principles for SEFs, including SEF core principle 6, and amended DCM core principle 5

The Dodd-Frank Act added a core principle concerning position limitations or accountability for SEFs, SEF core principle 6, which parallels DCM core principle 5.[635] SEF core principle 6 requires SEFs that are trading facilities to set, "as is necessary and appropriate, position limitations or position accountability for speculators"[636] for each

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[632] The SEF definition is added in section 721 of the Dodd-Frank Act, amending CEA section 1a. 7 U.S.C. 1a(50).

[633] See CEA section 5h, as enacted by section 733 of the Dodd-Frank Act; 7 U.S.C. 7b-3.

[634] See id.; see also SEF core principle 1 at CEA section 5h(f)(1)(B); 7 U.S.C. 7b-3(f)(1)(B).

[635] Compare CEA section 5h(f)(6); 7 U.S.C. 7b-3(f)(6) with CEA section 5(d)(5); 7 U.S.C. 7(d)(5).

[636] CEA section 5h(f)(6)(A); 7 U.S.C. 7b-3(f)(6).

contract executed pursuant to their rules. Furthermore, for contracts subject to Federal position limits imposed by the Commission under CEA section 4a(a), CEA section 5h(f)(6)(B)[637] requires SEFs that are trading facilities to set and enforce speculative position limits at a level no higher than those established by the Commission.

The Dodd-Frank Act similarly amended DCM core principle 5 by adding that for any contract that is subject to a position limit established by the Commission pursuant to CEA section 4a(a), the DCM shall set the position limit of the board of trade at a level not higher than the position limitation established by the Commission.[638]

5. Dodd-Frank Rulemaking

To implement section 735 of the Dodd-Frank Act, the Commission has proposed a number of new and revised rules, guidance, and acceptable practices to implement the new and revised DCM core principles. In doing so, the Commission has evaluated the preexisting regulatory framework for overseeing DCMs, which consisted largely of guidance and acceptable practices, in order to update those provisions and to determine which core principles would benefit from having new or revised derivative regulations. Based on that review, and in view of the Dodd-Frank Act's amendment to section 5(d)(1) of the CEA, which grants the Commission authority to determine, by rule or regulation, the manner in which boards of trade comply with the core principles, the Commission has proposed revised guidance and acceptable practices for some core principles and, for other core principles, has proposed to codify rules in lieu of guidance and acceptable practices.

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[637] 7 U.S.C. 7b-3(f)(6) as added by the Dodd-Frank Act.

[638] See CEA section 5(d)(1)(B); 7 U.S.C. 7(d)(1)(B). DCM core principle 5 under CEA section 5(d)(5) requires that DCMs adopt for each contract, as is necessary and appropriate, position limitations or position accountability.

i. Amended part 38

In January 2011, the Commission published a notice of proposed rulemaking to replace existing part 150, in its entirety, with a new federal position limits rules regime in the form of new part 151.[639] Just one month prior to this publication, the Commission published a notice of proposed rulemaking to amend part 38 to establish regulatory obligations that each DCM must meet in order to comply with section 5 of the CEA, as amended by the Dodd-Frank Act. Accordingly, the Commission proposed § 38.301 to require that each DCM must comply with the requirements of part 151 as a condition of its compliance with DCM core principle 5.[640] The Commission later adopted a revised version of § 38.301 with an additional clause that requires DCMs to continue to meet the requirements of part 150 of the Commission's regulations — the current position limit regulations — until such time that compliance would be required under part 151.[641] The Commission explained that this clarification would ensure that DCMs are in compliance with the Commission's regulations under part 150 during the interim period until the compliance date for the new position limits regulations of part 151 would take effect.[642] The Commission further explained that new § 38.301 was based on the Dodd-Frank amendments to the DCM core principles regime, which collectively provide that DCM

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[639] Position Limits for Derivatives, Proposed Rule, 76 FR 4752, Jan. 26, 2011. The final rulemaking for vacated part 151 required DCMs to comply with part 150 until such time that the Commission replaces part 150 with the new part 151. See 76 FR at 71632.

[640] 75 FR 80571, 80585, Dec. 22, 2010.

[641] 77 FR 36611, 36639, Jun. 19, 2012. The Commission mandated in final § 38.301 that, in order to comply with DCM core principle 5, a DCM must "meet the requirements of parts 150 and 151 of this chapter, as applicable." See also 17 CFR 38.301.

[642] 77 FR at 36639.

discretion in setting position limits or position accountability levels is limited by Commission regulations setting limits.[643]

However, in an Order dated September 28, 2012, the United States District Court for the District of Columbia vacated part 151.[644] The District Court's decision did not affect the applicability of part 150.[645] Therefore, part 150 continues to apply as if part 151 had not been finally adopted by the Commission, and § 150.5 continues to apply as non-exclusive guidance and acceptable practices for compliance with DCM core principle 5. In light of the foregoing, the Commission could not, without notice, interpret § 150.5 as a pre-requisite for compliance with core principle 5. Additionally, the Commission is proposing to amend § 38.301 by deleting the reference to vacated part 151. Proposed § 38.301 would maintain the requirement that DCMs meet the requirements of part 150, as applicable.

ii. Amended part 37

Similarly, in the Commission's proposal to adopt a regulatory scheme applicable to SEFs, under proposed § 37.601,[646] the Commission proposed to require that SEFs establish position limits in accordance with the requirements set forth in part 151 of the Commission's regulations.[647] In the SEF final rulemaking, the Commission revised § 37.601 to state that until such time that compliance is required under part 151, a SEF may

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[643] Id. See also CEA sections 5(d)(1) and 5(d)(5) (amended 2010), and discussion supra of Dodd-Frank amendments to the DCM core principles.

[644] See 887 F. Supp. 2d 259 (D.D.C. 2012).

[645] See id generally.

[646] Current § 37.601 provides requirements for SEFs that are trading facilities to comply with SEF core principle 6 (Position Limits or Accountability).

[647] Core Principles and Other Requirements for Swap Execution Facilities, 76 FR 1214 (proposed Jan. 7, 2011).

refer to the guidance and/or acceptable practices in appendix B of part 37 to demonstrate to the Commission compliance with the requirements of core principle 6.

In light of the District Court vacatur of part 151, the Commission proposes to amend § 37.601 to delete the reference to vacated part 151. Instead, this rulemaking proposes to require that SEFs that are trading facilities meet the requirements of part 150, which are comparable to the DCM's requirement, since, as proposed, § 150.5 would apply to commodity derivative contracts, whether listed on a DCM or on a SEF that is a trading facility. In addition, the Commission proposes to amend appendix B to part 37, which provides guidance on complying with core principles, both initially and on an ongoing basis, to maintain SEF registration.[648] Since this rulemaking proposes to require that SEFs that are trading facilities meet the requirements of part 150, the proposed amendments to the guidance regarding SEF core principle 6 would reiterate that requirement. For SEFs that are not trading facilities, to whom core principle 6 is not applicable under the statutory language, the proposal would provide that part 150 should be considered as guidance.

iii. <u>Vacated part 151</u>

As discussed above, the United States District Court for the District of Columbia vacated part 151 of the Commission's regulations.[649] Because the District Court's decision did not affect the applicability of part 150, current § 150.5 remains as guidance and acceptable practices for compliance with DCM core principle 5 and SEF core principle 6. The Commission continues to rigorously enforce compliance with these core principles.

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[648] Appendix B to Part 37 — Guidance on, and Acceptable Practices in, Compliance with Core Principles.

[649] See 887 F. Supp. 2d 259 (D.D.C. 2012).

Vacated § 151.11 would have required DCMs and SEFs to adopt position limits for Referenced Contracts, and would have established acceptable practices for establishing position limits and position accountability for certain non-referenced contracts and excluded commodities.[650] Specifically, vacated § 151.11(a) would have required DCMs and SEFs to set spot month limits, with exceptions for securities futures and some excluded commodities.[651] Under vacated § 151.11(a)(1), the Commission would have required DCMs and SEFs to establish spot-month limits for Referenced Contracts at levels no greater than the federal position limits (established pursuant to vacated § 151.4).[652] For contracts other than Referenced Contracts (including other physical commodity contracts), it would be acceptable practice under vacated § 151.11(a)(2) for DCMs and SEFs to set position limits at levels no greater than 25 percent of estimated deliverable supply.[653] Additionally, under vacated § 151.11(c), DCMs and SEFs would have had discretion to establish position accountability levels in lieu of position limits for excluded commodities under certain circumstances.[654]

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[650] See 76 FR at 71659-61.

[651] 76 FR at 71659.

[652] 76 FR at 71659–60. For Referenced Contracts, DCMs and SEFs would have been similarly required under vacated § 151.11(b) to set single non-spot-month and all-months limits for Referenced Contracts at levels no higher than the federal position limits (established pursuant to vacated § 151.4). Id. For non-referenced contracts, it would be acceptable practice under vacated § 151.11(b)(2) for DCMs and SEFs to impose limits based on ten percent of the average combined futures, swaps and delta-adjusted option month-end open interest for the most recent two calendar years up to 25,000 contracts, with a marginal increase of 2.5 percent thereafter based on open interest in the contract and economically equivalent contracts traded on the same DCM or SEF. 76 FR 71661.

[653] 76 FR at 71660. Furthermore, for non-referenced contracts, vacated § 151.11(b)(3) would have allowed as an acceptable practice the provision of speculative limits for an individual single-month or in all-months-combined at no greater than 1,000 contracts for non-energy physical commodities and at no greater than 5,000 contracts for other commodities. Id.

[654] Id. Position accountability levels could be used in lieu of position limits only if the contract involves either a major currency or certain excluded commodities (such as measures of inflation, or other macroeconomic measures) or an excluded commodity that: (1) has an average daily open interest of 50,000 or more contracts, (2) has an average daily trading volume of 100,000 or more contracts, and (3) has a highly liquid cash market. Id. Compare this vacated provision with current 17 CFR 150.5(e). As for

Vacated §§ 151.11(e) and 151.11(f) would have required DCMs and SEFs to follow the same account aggregation and bona fide exemption standards set forth by vacated §§ 151.5 and 151.7 with respect to exempt and agricultural commodities.[655] With respect to a DCM's or SEF's duty to administer hedge exemptions, the Commission intended that DCMs and SEFs administer their own position limits under § 151.11.[656] Accordingly, the Commission had required under this vacated rulemaking that DCMs and SEFs create rules and procedures to allow traders to claim a bona fide hedge exemption, consistent with vacated § 151.5 for physical commodity derivatives and § 1.3(z), as was amended in the vacated rulemaking, for excluded commodities.[657]

C. Proposed Amendments to § 150.5

To implement section 735 of the Dodd-Frank Act regarding DCMs, the Commission continues to adopt new and revised rules, guidance, and acceptable practices to implement the DCM core principles added and revised by the Dodd-Frank Act. The Commission continues to evaluate its pre-Dodd-Frank Act regulations and approach to oversight of DCMs, which had consisted largely of published guidance and acceptable

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physical commodities, under vacated § 151.11(c), the Commission would have allowed a DCM or SEF to establish position accountability rules as an acceptable alternative to position limits outside of the spot month for physical commodity contracts when a contract has an average month-end open interest of 50,000 contracts and an average daily volume of 5,000 contracts and a liquid cash market. Id.

[655] Id. Furthermore, under vacated § 151, the Commission would have removed the procedure to apply to the Commission for bona fide hedge exemptions for non-enumerated transactions or positions under § 1.3(z)(3). Id. DCMs and SEFs would have been able to recognize non-enumerated hedge transactions subject to Commission review. Id. Additionally, DCMs and SEFs could continue to provide exemptions for "risk-reducing" and "risk-management" transactions or positions consistent with existing Commission guidelines. Id. (citing Clarification of Certain Aspects of Hedging Definition, 52 FR 27195, Jul. 20, 1987; and Risk Management Exemptions from Speculative Position Limits Approved under Commission Regulation 1.61, 52 FR 34633, Sep. 14, 1987). Vacated § 151.11(f)(2) would have required traders seeking a hedge exemption to comply with the procedures of the DCM or SEF for granting exemptions from its speculative position limit rules. 76 FR 71660–61.

[656] 76 FR at 71661.

[657] Id. Vacated § 151.11 contemplated that DCMs and SEFs would administer their own bona fide hedge exemption regime in parallel to the Commission's regime.

practices, with the aim of updating them to conform to the new Dodd-Frank Act regulatory framework. Based on that review, and pursuant to the authority given to the Commission in amended sections 5(d)(1) and 5h(f)(1) of the CEA, which permit the Commission to determine, by rule or regulation, the manner in which boards of trade and SEFs, respectively, must comply with the core principles,[658] the Commission is proposing several updates to § 150.5 to promote compliance with DCM core principle 5 and SEF core principle 6.

First, the Commission proposes amendments to the provisions of § 150.5 to include SEFs and swaps. Second, the Commission proposes to codify rules and revise acceptable practices for compliance with DCM core principle 5 and SEF core principle 6 within amended § 150.5(a) for contracts subject to the federal position limits set forth in § 150.2. Lastly, the Commission proposes to codify rules and revise guidance and acceptable practices for compliance with DCM core principle 5 and SEF core principle 6 within amended § 150.5(b) for contracts not subject to the federal position limits set forth in § 150.2.

As noted above, the CFMA core principles regime concerning position limitations or accountability for exchanges had the effect of undercutting the mandatory rules promulgated by the Commission in § 150.5. Since the CFMA amended the CEA in 2000, the Commission has retained § 150.5, but only as guidance on, and acceptable practice for, compliance with DCM core principle 5.[659] However, the Commission did not amend the text of § 150.5 following passage of CFMA, leaving language in place that could suggest that the rules originally codified within § 150.5 remain mandatory for exchanges.

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[658] See CEA sections 5(d)(1)(B) and 5h(f)(1)(B); 7 U.S.C. 7(d)(1)(B) and 7b-3(f)(1)(B).

[659] See id.

To correct this potential misimpression, the Commission now proposes several amendments to § 150.5 to clarify that certain provisions of § 150.5 are non-exclusive guidance on, and acceptable practice for, compliance with DCM core principle 5.

Additionally, the Commission is proposing several conforming amendments to § 150.5 in order to integrate that section more fully with the statutory framework created by the Dodd-Frank Act. The Commission, pursuant to the factors enumerated in section 4a(a)(3) of the Act, has endeavored to maximize the objectives of preventing excessive speculation, deterring and preventing market manipulation, ensuring that markets remain sufficiently liquid so as to afford end users and producers of commodities the ability to hedge commercial risks, and promoting efficient price discovery. These proposed clarifying revisions to § 150.5 should also provide exchanges with sufficient flexibility to address the divergent and changing conditions in their respective markets.

Within amended § 150.5(a), the Commission proposes to codify a set of rules and revise acceptable practices for compliance with DCM core principle 5 and SEF core principle 6 for contracts that are subject to the federal position limits set forth in § 150.2. Within amended § 150.5(b), the Commission proposes to codify rules and revise guidance and acceptable practices for compliance with DCM core principle 5 and SEF core principle 6 for contracts that are not subject to the federal position limits set forth in § 150.2.

Unlike current § 150.5, which contains only non-exclusive guidance on and acceptable practices for compliance with DCM core principle 5 (despite the presence of language that connotes mandatory rules), proposed § 150.5 contains a mix of rules that would be mandatory for compliance with DCM core principle 5 and SEF core principle

6, coupled with guidance and acceptable practices for compliance with those core principles. Accordingly, the Commission urges the reader to pay special attention to the language in proposed § 150.5 that distinguishes mandatory rules (indicated by terms such as "must" and "shall") from guidance and acceptable practices (indicated by terms such as "should" or "may").

Additionally, the Commission proposes to amend § 150.5 to implement uniform requirements for DCMs and SEFs relating to hedging exemptions across all types of contracts, including those that are subject to federal limits. The Commission also proposes to require DCMs and SEFs to have aggregation policies that mirror the federal aggregation provisions.[660] Hedging exemptions and position aggregation exemptions, if not uniform with the Commission's requirements, may serve to permit a person to obtain a larger position on a particular DCM or SEF than would be permitted under the federal limits. For example, if an exchange were to grant an aggregation position to a corporate person with aggregate positions above federal limits, that exchange may permit such person to be treated as two or more persons. The person would avoid violating exchange limits, but may be in violation of the federal limits. The Commission believes that a DCM or SEF, consistent with its responsibilities under applicable core principles, may serve an important role in ensuring compliance with federal positions limits and thereby protect the price discovery function of its market and guard against excessive speculation or manipulation. In the absence of uniform hedging and position aggregation exemptions, DCMs or SEFs may not serve that role. The Commission notes that hedging

[660] Aggregation exemptions are, in effect, a way for a trader to acquire a larger speculative position. The Commission believes that it is important that the aggregation rules set out, to the extent feasible, "bright line" standards that are capable of easy application by a wide variety of market participants while not being susceptible to circumvention.

exemptions and aggregation policies that vary from exchange to exchange would increase the administrative burden on a trader active on multiple exchanges, as well as increase the administrative burden on the Commission in enforcing exchange-set position limits.

The essential features of the proposed amendments to § 150.5 are summarized below.

1. Proposed amendments to § 150.5 to add references to swaps and swap execution facilities

As discussed above, the Dodd-Frank Act created a new type of regulated marketplace, SEFs, for which it established a comprehensive regulatory framework. A SEF must comply with fifteen enumerated core principles and any requirement that the Commission may impose by rule or regulation.[661] The Dodd-Frank Act provides that the Commission may, in its discretion, determine by rule or regulation the manner in which SEFs comply with the core principles.[662]

For contracts that are subject to federal position limits imposed under CEA section 4a(a), new CEA section 5h(f)(6)(A)[663] requires that SEFs set "as is necessary and appropriate, position limitations or position accountability for speculators" for each contract executed pursuant to their rules.[664] New CEA section 5h(f)(6)(B),[665] requires SEFs that are trading facilities to set and enforce speculative position limits at a level no

[661] See supra discussion of SEF core principles.

[662] See CEA section 5h(f)(1)(B); 7 U.S.C. 7b-3(f)(1)(B).

[663] As added by section 723 of the Dodd-Frank Act.

[664] A similar duty is imposed on DCMs under CEA section 5(d)(5)(A); 7 U.S.C. 7(d)(5)(A).

[665] As added by section 723 of the Dodd-Frank Act.

higher than those established by the Commission.[666] The Commission recognizes that SEFs may need to contract with derivative clearing organizations in order to comply with SEF core principle 6. The Commission invites comments on the practicability and effectiveness of such arrangements. In addition, the Commission invites comment as to whether the Commission should use its exemptive authority under CEA section 4a(a)(7) to exempt SEFs from the requirements of CEA section 5h(f)(6)(B). If so, why and to what extent?

The Commission carefully considered both the novel nature of SEFs and its experience in overseeing DCMs' compliance with core principles when determining which SEF core principles to address with rules that would provide more certainty to the marketplace, and which core principles to address with guidance or acceptable practices that might provide more flexibility. The Commission has determined that the policy purposes effectuated by establishing uniform requirements for aggregation and bona fide hedging exemptions for DCM contracts are equally present in SEF markets.[667] Accordingly, the Commission has determined to amend § 150.5 to present essentially identical standards for establishing rules and acceptable practices relating to position limits (and accountability levels) for DCMs and SEFs.

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[666] This requirement for SEFs parallels that for DCMs as listed in the CEA section 5(d)(5)(B); 7 U.S.C. 7(d)(5)(B).

[667] See core principle 6 for SEFs, CEA section 5h(f)(6)(A); 7 U.S.C. 7b–3(f)(6)(A). The Commission notes that section 4a(a)(2) of the CEA requires the Commission to establish speculative position limits on physical commodity DCM contracts as appropriate, but did not extend this requirement to SEF contracts. See discussion above.

2. Proposed § 150.5(a) — Requirements and acceptable practices for commodity derivative contracts that are subject to federal position limits

Proposed § 150.5(a) adds several requirements that a DCM or SEF must adhere to when setting position limits for contracts that are subject to the federal position limits listed in § 150.2.[668] Proposed § 150.5(a)(1) specifies that a DCM or SEF that lists a contract on a commodity that is subject to federal position limits must adopt position limits for that contract at a level that is no higher than the federal position limit.[669] Exchanges with cash-settled contracts price-linked to contracts subject to federal limits must also adopt those limit levels.

Proposed § 150.5(a)(2) prescribes the manner in which a DCM or SEF that lists a contract on a commodity that is subject to federal position limits must adopt hedge exemption rules. Proposed § 150.5(a)(2)(i) cross-references the definition of bona fide hedging, as proposed in amended § 150.1, as the regulation governing bona fide hedging positions.[670] Proposed § 150.5(a)(2)(ii) clarifies the types of spread positions for which a DCM or SEF may grant exemptions from the federal limits by cross-referencing the definitions of intermarket and intramarket spread positions in proposed § 150.1.[671] To be

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[668] As discussed above, 17 CFR 150.2 provides limits for specified agricultural contracts in the spot month, individual non-spot months, and all-months-combined.

[669] Proposed § 150.5(a)(1) is in keeping with the mandate in core principle 5 as amended by the Dodd-Frank Act. See CEA section 5(d)(1)(B); 7 U.S.C. 7(d)(1)(B). SEF core principle 6 parallels DCM core principle 5. Compare CEA section 5h(f)(5); 7 U.S.C. 7b-3(f)(5) with CEA section 5(d)(5); 7 U.S.C. 7(d)(5).

[670] Compare 17 CFR 150.5(d) which explicitly precludes exchanges from applying exchange-set speculative position limits rules to bona fide hedging positions as defined by the exchange in accordance with § 1.3(z)(1).

[671] The Commission has proposed to maintain the current practice in 17 CFR 150.2 of setting single-month limits at the same levels as all-months limits, rendering the "spread" exemption in 17 CFR 150.3 unnecessary. However, since DCM core principle 5 allows exchanges to set more restrictive limits than the federal limits, a DCM or SEF may set the single month limit at a level lower than that of the all-month limit, an exemption for intramarket spread position may be useful. See CEA section 5(d)(5); 7 U.S.C.

eligible for exemption under proposed § 150.5(a)(2)(ii), intermarket and intramarket spread positions must be outside of the spot month for physical delivery contracts, and intramarket spread positions must not exceed the federal all-months limit when combined with any other net positions in the single month. Proposed § 150.5(a)(2)(iii) would require traders to apply to the DCM or SEF for any exemption from its speculative position limit rules.[672] Proposed § 150.5(a)(2)(iii) also preserves the exchange's ability to limit bona fide hedging positions which it determines are not in accord with sound commercial practices, or which exceed an amount that may be established and liquidated in an orderly fashion.[673]

Proposed § 150.5(a)(3)(i) requires a DCM or SEF to exempt from speculative position limits established under § 150.2 a swap position acquired in good faith prior to the effective date of such limits.[674] However, proposed § 150.5(a)(3)(i) would allow a person to net such a pre-existing swap with post-effective date commodity derivative contracts for the purpose of complying with any non-spot-month speculative position limit. Furthermore, proposed § 150.5(a)(3)(ii) requires a DCM or SEF to exempt from non-spot-month speculative position limits established under § 150.2 any commodity

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7(d)(5). An exemption for intramarket spread positions would be unnecessary if the DCM or SEF sets the single month limit at the same level as the all-months limit.

Additionally, the duplicative term "arbitrage" would be removed because CEA section 4a(a)(1) explains that "the word 'arbitrage' in domestic markets shall be defined to mean the same as 'spread' or 'straddle.'" 7 U.S.C. 6a(a)(1).

[672] Hence, proposed § 150.5(a)(2)(C) would codify as a requirement for DCMs and SEFs the acceptable practice concerning application for exemption listed in 17 CFR 150.5(d)(2).

[673] Proposed § 150.5(a)(2)(C) presents guidance that largely mirrors the guidance provided in the second half of 17 CFR 150.5(d), with edits to specify DCMs and SEFs.

[674] The Commission is exercising its authority under CEA section 4a(a)(7) to exempt pre-Dodd-Frank and transition period swaps from speculative position limits (unless the trader elects to include such a position to net with post-effective date commodity derivative contracts). Such a pre-existing swap position will be exempt from initial spot month speculative position limits.

derivative contract acquired in good faith prior to the effective date of such limit. However, such a pre-existing commodity derivative contract position must be attributed to the person if the person's position is increased after the effective date of such limit.[675]

The Commission proposes to require DCMs and SEFs to have aggregation polices that mirror the federal aggregation provisions.[676] Therefore, proposed § 150.5(a)(4) requires DCMs and SEFs to have aggregation rules that conform to the uniform standards listed in § 150.4.[677]

A DCM or SEF would continue to be free to enforce position limits that are more stringent that the federal limits. The Commission clarifies that federal spot month position limits do not to apply to physical-delivery contracts after delivery obligations are established.[678] Exchanges generally prohibit transfer or offset of positions once long and short position holders have been assigned delivery obligations. Proposed §150.5(a)(6) would clarify acceptable practices for a DCM or SEF to enforce spot month limits against the combination of, for example, long positions that have not been stopped, stopped positions, and deliveries taken in the current spot month.[679]

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[675] Notwithstanding any pre-existing exemption adopted by a DCM or SEF that applies to speculative position limits in non-spot months, a person holding pre-existing commodity derivative contracts (except for pre-existing swaps as described above) must comply with spot month speculative position limits. However, nothing in proposed § 150.5(a)(3)(B) would override the exclusion of pre-Dodd-Frank and transition period swaps from speculative position limits.

[676] See supra discussion concerning aggregation.

[677] Proposed § 150.5(a)(4) references 17 CFR 150.4 as the regulation governing aggregation for contracts subject to federal position limits and would replace 17 CFR 150.5(g). See supra the Commission's explanation for implementing uniform aggregation standards across DCMs and SEFs.

[678] Therefore, federal spot month position limits do not apply to positions in physical-delivery contracts on which notices of intention to deliver have been issued, stopped long positions, delivery obligations established by the clearing organization, or deliveries taken.

[679] For example, an exchange may restrict a speculative long position holder that otherwise would obtain a large long position, take delivery, and seek to re-establish a large long position in an attempt to corner a significant portion of the deliverable supply or to squeeze shorts. Proposed §150.5(b)(9) would set forth the same acceptable practices for contracts not subject to federal limits.

3. Proposed § 150.5(b) — Requirements and acceptable practices for commodity derivative contracts that are not subject to federal position limits

The Commission sets forth in proposed § 150.5(b) requirements and acceptable practices applicable to DCM- and SEF-set speculative position limits for any contract that is not subject to federal position limits, including physical and excluded commodities.[680]

As discussed above, the Commission proposes to revise § 150.5 to implement uniform requirements for DCMs and SEFs relating to hedging exemptions across all types of commodity derivative contracts, including those that are not subject to federal position limits. The Commission further proposes to require DCMs and SEFs to have uniform aggregation polices that mirror the federal aggregation provisions for all types of commodity derivative contracts, including for contracts that are not subject to federal position limits. As explained above, hedging exemptions and aggregation policies that vary from exchange to exchange would increase the administrative burden on a trader active on multiple exchanges, as well as increase the administrative burden on the Commission in monitoring and enforcing exchange-set position limits.

Therefore, proposed § 150.5(b)(5)(i) would require any hedge exemption rules adopted by a designated contract market or a swap execution facility that is a trading facility to conform to the definition of bona fide hedging position in proposed § 150.1. In addition to this affirmative rule, proposed § 150.5(b)(5) would set forth acceptable practices for DCMs and SEFs to grant exemptions from position limits for positions, other than bona fide hedging positions, in contracts not subject to federal limits. Such exemptions generally track the exemptions set forth in proposed § 150.3, and are

[680] For position limits purposes, proposed § 150.1(k) would define "physical commodity" to mean any agricultural commodity, as defined in 17 CFR 1.3, or any exempt commodity, as defined in section 1a(20) of the Act. Excluded commodity is defined in section 1a(19) of the Act.

suggested as acceptable practices based on the same logic that underpins the proposed § 150.3 exemptions.[681] It would be acceptable practice for a DCM or SEF to grant exemptions under certain circumstances for financial distress, intramarket and intermarket spreads, and qualifying cash-settled contract positions in the spot month.[682] Additionally, proposed §150.5(b)(5)(ii) would set forth an acceptable practice for a DCF or SEF to grant a limited risk management exemption for contracts on excluded commodities pursuant to rules submitted to the Commission, and consistent with the guidance in new appendix A to part 150.[683]

Proposed §150.5(b)(6) and (7) set forth acceptable practices relating to pre-enactment and transition period swap positions (as those terms are defined in proposed § 150.1),[684] and to commodity derivative contract positions acquired in good faith prior to the effective date of mandatory federal speculative position limits.

Additionally, for any contract that is not subject to federal position limits, proposed § 150.5(b)(8) requires the DCM or SEF to conform to the uniform federal aggregation provisions.[685] This proposed requirement generally mirrors the requirement

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[681] See supra discussion of the § 150.3 exemptions.

[682] See id.

[683] New appendix A to part 150 is intended to capture the essence of the Commission's 1987 interpretation of its definition of bona fide hedge transactions to permit exchanges to grant hedge exemptions for various risk management transactions. See Risk Management Exemptions From Speculative Position Limits Approved Under Commission Regulation 1.61, 52 FR 34633, Sep. 14, 1987. The Commission specified that such exemptions be granted on a case-by-case basis, subject to a demonstrated need for the exemption. It also required that applicants for these exemptions be typically engaged in the buying, selling, or holding of cash market instruments. See id. Additionally, the Commission required the exchanges to monitor the exemptions they granted to ensure that any positions held under the exemption did not result in any large positions that could disrupt the market. See id. The term "excluded commodity" is defined in CEA section 1(a)(19).

[684] See supra discussion of pre-enactment and transition period swap positions.

[685] Proposed § 150.5(b)(7) would replace 17 CFR 150.5(g) as it relates to contracts that are not subject to federal position limits.

in proposed § 150.5(a)(4) for contracts that are subject to federal position limits by requiring the DCM or SEF to have aggregation rules that conform to § 150.4.

The Commission proposes in § 150.5(b) to generally update and reorganize the set of acceptable practices listed in current § 150.5 as it relates to contracts that are not subject to the federal position limits. For existing and newly established DCMs and newly established SEFs, these acceptable practices generally concern how to: (1) set spot-month position limits; (2) set individual non-spot month and all-months-combined position limits; (3) set position limits for cash-settled contracts that use a reference contract as a price source; (4) adjust position limit levels after a contract has been listed for trading; and (5) adopt position accountability in lieu of speculative position limits.

For a derivative contract that is based on a commodity with a measurable deliverable supply, proposed § 150.5(b)(1)(i)(A) updates the acceptable practice in current § 150.5(b)(1) whereby spot month position limits should be set at a level no greater than one-quarter of the estimated deliverable supply of the underlying commodity.[686] Proposed § 150.5(b)(1)(i)(A) clarifies that this acceptable practice for setting spot month position limits would apply to any commodity derivative contract, whether physical-delivery or cash-settled, that has a measurable deliverable supply.[687]

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[686] Proposed § 150.5(b)(1)(i)(A) is consistent with the Commission's longstanding policy regarding the appropriate level of spot-month limits for physical delivery contracts. These position limits would be set at a level no greater than 25 percent of estimated deliverable supply. The spot-month limits would be reviewed at least every 24 months thereafter. The proposed deliverable supply formula narrowly targets the trading that may be most susceptible to, or likely to facilitate, price disruptions. The formula seeks to minimize the potential for corners and squeezes by facilitating the orderly liquidation of positions as the market approaches the end of trading and by restricting swap positions that may be used to influence the price of referenced contracts that are executed centrally.

[687] In general, the term "deliverable supply" means the quantity of the commodity meeting a derivative contract's delivery specifications that can reasonably be expected to be readily available to short traders and saleable to long traders at its market value in normal cash marketing channels at the derivative contract's delivery points during the specified delivery period, barring abnormal movement in interstate

For a derivative contract that is based on a commodity without a measurable deliverable supply, proposed § 150.5(b)(1)(i)(B) would codify as guidance that the spot month limit level should be no greater than necessary and appropriate to reduce the potential threat of market manipulation or price distortion of the contract's or the underlying commodity's price.[688]

Proposed § 150.5(b)(1)(ii)(A) preserves the existing acceptable practice in current § 150.5(b)(2) whereby individual non-spot or all-months-combined levels for agricultural commodity derivative contracts that are not subject to the federal limits should be no greater than 1,000 contracts at initial listing. The proposed rule would also codify as guidance that the 1,000 contract limit should be taken into account when the notional quantity per contract is no larger than a typical cash market transaction in the underlying commodity, or reduced if the notional quantity per contract is larger than a typical cash market transaction.[689] Additionally, proposed § 150.5(b)(1)(ii)(A) would codify that if the commodity derivative contract is substantially the same as a pre-existing DCM or SEF commodity derivative contract, then it would be an acceptable practice for the DCM

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commerce. Proposed § 150.1 would define commodity derivative contract to mean any futures, option, or swap contract in a commodity (other than a security futures product as defined in CEA section 1a(45)).

[688] This descriptive standard is largely based on the language of DCM core principle 5 and SEF core principle 6. The Commission does not suggest that an excluded commodity derivative contract that is based on a commodity without a measurable supply should adhere to a numeric formula in setting spot month position limits.

[689] The Commission explained what it considers to be a "typical cash market transaction" in the preamble for final part 151 (subsequently vacated): "[f]or example, if a DCM or SEF offers a new physical commodity contract and sets the notional quantity per contract at 100,000 units while most transactions in the cash market for that commodity are for a quantity of between 1,000 and 10,000 units and exactly zero percent of cash market transactions are for 100,000 units or greater, then the notional quantity of the derivatives contract offered by the DCM or SEF would be atypical. This clarification is intended to deter DCMs and SEFs from setting non-spot-month position limits for new contracts at levels where they would constitute non-binding constraints on speculation through the use of an excessively large notional quantity per contract. This clarification is not expected to result in additional marginal cost because, among other things, it reflects current Commission custom in reviewing new contracts and is an acceptable practice for core principle compliance and not a requirement per se for DCMs or SEFs." See 76 FR 71660.

or SEF to adopt the same limit as applies to that pre-existing commodity derivative contract.[690]

Proposed § 150.5(b)(1)(ii)(B) preserves the existing acceptable practice, set forth in current § 150.5(b)(3), for DCMs to set individual non-spot or all-months-combined limits at levels no greater than 5,000 contracts at initial listing, but would apply this acceptable practice on a wider scale to both exempt and excluded commodity derivative contracts.[691] Proposed § 150.5(b)(1)(ii)(B) would codify as guidance for exempt and excluded commodity derivative contracts that the 5,000 contract limit should be applicable when the notional quantity per contract is no larger than a typical cash market transaction in the underlying commodity, or should be reduced if the notional quantity per contract is larger than a typical cash market transaction. Additionally, proposed § 150.5(b)(1)(B)(ii) would codify a new acceptable practice for a DCM or SEF to adopt the same limit as applies to the pre-existing contract if the new commodity contract is substantially the same as an existing contract.

Proposed § 150.5(b)(1)(iii) sets forth that if a commodity derivative contract is cash-settled by referencing a daily settlement price of an existing contract listed on a DCM or SEF, then it would be an acceptable practice for a DCM or SEF to adopt the same position limits as the original referenced contract, assuming the contract sizes are the same. Based on its enforcement experience, the Commission believes that limiting a trader's position in cash-settled contracts in this way diminishes the incentive to exert

[690] In this context, "substantially the same" means a close economic substitute. For example, a position in Eurodollar futures can be a close economic substitute for a fixed-for-floating interest rate swap.

[691] In contrast, 17 CFR 150.5(b)(3) lists this as an acceptable practice for contracts for energy products and non-tangible commodities. Excluded commodity is defined in CEA section 1a(19), and exempt commodity is defined CEA section 1a(20).

market power to manipulate the cash-settlement price or index to advantage a trader's position in the cash-settled contract.[692]

Proposed § 150.5(b)(2)(i) updates the acceptable practices in current § 150.5(c) for adjusting limit levels for the spot month. For a derivative contract that is based on a commodity with a measurable deliverable supply, proposed § 150.5(b)(2)(i) maintains the acceptable practice in current § 150.5(c) to adjust spot month position limits to a level no greater than one-quarter of the estimated deliverable supply of the underlying commodity, but would apply this acceptable practice to any commodity derivative contract, whether physical-delivery or cash-settled, that has a measurable deliverable supply. For a derivative contract that is based on a commodity without a measurable deliverable supply, proposed § 150.5(b)(1)(i)(B) would codify as guidance that the spot month limit level should not be adjusted to levels greater than necessary and appropriate to reduce the potential threat of market manipulation or price distortion of the contract's or the underlying commodity's price. Proposed § 150.5(b)(2)(i) would codify as a new acceptable practice that spot month limit levels be reviewed no less than once every two years.

Proposed § 150.5(b)(2)(ii) maintains as an acceptable practice the basic formula set forth in current § 150.5(c)(2) for adjusting non-spot-month limits at levels of no more than 10% of the average combined futures and delta-adjusted option month-end open interest for the most recent calendar year up to 25,000 contracts, with a marginal increase of 2.5% of the remaining open interest thereafter. Proposed § 150.5(b)(2)(ii) would also

[692] With respect to cash-settled contracts where the underlying product is a physical commodity with limited supplies, enabling a trader to exert market power (including agricultural and exempt commodities), the Commission has viewed the specification of speculative position limits to be an essential term and condition of such contracts in order to ensure that they are not readily susceptible to manipulation, which is the DCM core principle 3 requirement.

maintain as an alternative acceptable practice the adjustment of non-spot-month limits to levels based on position sizes customarily held by speculative traders in the contract. Proposed § 150.5(b)(3) generally updates and reorganizes the existing acceptable practices in current § 150.5(e) for a DCM or SEF to adopt position accountability rules in lieu of position limits, under certain circumstances, for contracts that are not subject to federal position limits. This proposed section reiterates the DCM's authority, with conforming changes for SEFs, to require traders to provide information regarding their position when requested by the exchange.[693] Proposed § 150.5(b)(3) would codify a new acceptable practice for a DCM or SEF to require traders to consent to halt from increasing their position in a contract if so ordered. Proposed § 150.5(b)(3) would also codify a new acceptable practice for a DCM or SEF to require traders to reduce their position in an orderly manner.

Proposed § 150.5(b)(3)(i) would maintain the acceptable practice for a DCM or SEF to adopt position accountability rules outside the spot month, in lieu of position limits, for an agricultural or exempt commodity derivative contract that: (1) has an average month-end open interest of 50,000 contracts and an average daily volume of 5,000 or more contracts during the most recent calendar year; (2) has a liquid cash market; and (3) is not subject to federal limits in § 150.2 — provided, however, that such DCM or SEF should adopt a spot month speculative position limit with a level no greater than one-quarter of the estimated spot month deliverable supply.[694]

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[693] Compare 17 CFR 150.5(e)(2)–(3).

[694] 17 CFR 150.5(e)(3) applies this acceptable practice to a "tangible commodity, including, but not limited to metals, energy products, or international soft agricultural products." Also, compare the "minimum open interest and volume test" in proposed § 150.5(b)(3)(i) with that in current § 150.5(e)(3).

For an excluded commodity derivative contract that has a highly liquid cash market and no legal impediment to delivery, proposed § 150.5(b)(3)(ii)(A) would maintain the acceptable practice for a DCM or SEF to adopt position accountability rules in the spot month in lieu of position limits. For an excluded commodity derivative contract without a measurable deliverable supply, proposed § 150.5(b)(3)(ii)(A) would codify an acceptable practice for a DCM or SEF to adopt position accountability rules in the spot month in lieu of position limits because there is not a deliverable supply that is subject to manipulation. However, for an excluded commodity derivative contract that has a measurable deliverable supply, but that may not be highly liquid and/or is subject to some legal impediment to delivery, proposed § 150.5(b)(3)(ii)(A) sets forth an acceptable practice for a DCM or SEF to adopt a spot-month position limit equal to no more than one-quarter of the estimated deliverable supply for that commodity, because the estimated deliverable supply may be susceptible to manipulation. Furthermore, proposed § 150.5(b)(3)(ii) would remove the "minimum open interest and volume" test for excluded commodity derivative contracts generally.[695] Proposed § 150.5(b)(3)(ii)(B) would codify an acceptable practice for a DCM or SEF to adopt position accountability levels for an excluded commodity derivative contract in lieu of position limits in the individual non-spot month or all-months-combined.

Proposed § 150.5(b)(3)(iii) adds a new acceptable practice for an exchange to list a new contract with position accountability levels in lieu of position limits if that new contract is substantially the same as an existing contract that is currently listed for trading

[695] The "minimum open interest and volume" test, as presented in 17 CFR 150.5(e)(1)–(2), need not be used to determine whether an excluded commodity derivative contract should be eligible for position accountability rules in lieu of position limits in the spot month.

on an exchange that has already adopted position accountability levels in lieu of position limits.[696]

Proposed § 150.5(b)(4) maintains the acceptable practice that for contracts not subject to federal position limits, DCMs and SEFs should calculate trading volume and open interest as established in current § 150.5(e)(4).[697] Proposed § 150.5(b)(4) would build upon these standards by accounting for swaps in reference contracts on a futures-equivalent basis.[698]

III. Related Matters

A. Considerations of Costs and Benefits

1. Background

Generally, speculative position limits cap the size of positions that a person may hold or control in commodity derivative contracts for speculative purposes.[699] First authorized in 1936,[700] position limits are not a new regulatory tool for containing

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[696] See supra discussion of what is meant by "substantially the same" in this context.

[697] For SEFs, trading volume and open interest for swaptions should be calculated on a delta-adjusted basis.

[698] "Futures-equivalent" is a defined term in proposed § 150.1 that accounts for swaps in referenced contracts.

[699] Derivative contracts — i.e., futures, options and swaps — may not transfer any ownership interest in the underlying commodity, but their prices are substantially derived from the value of the underlying commodity. Those who purchase or sell derivatives do so either to hedge or speculate. Generally, hedging is the use of derivatives markets by commodity producers, merchants or end-users to manage their exposure to fluctuation in the price of a commodity that a producer or user intends to use or produce; speculation, in contrast, is the use of derivative markets to profit from price appreciation or depreciation in the underlying commodity. Because the limits only restrict positions obtained for speculative purposes, this discussion refers interchangeably to "position limits," "speculative position limits," or "speculative limits."

[700] Congress first granted the CEC, a Commodity Futures Trading Commission predecessor, authority to set speculative position limits as part of the New Deal reforms enacted in the Commodity Exchange Act of 1936. Pub. L. No. 74-765, 49 Stat. 1491, 1492 (codified at 7 U.S.C. 6a(1) (1940)). Specifically, Congress authorized the CEC to "fix such limits on the amount of trading…which may be done by any person as the [CEC] finds is necessary to diminish, eliminate, or prevent such burden." Congress exempted positions attributable to bona fide hedging. Unless otherwise indicated, references in this discussion to the "Commission" mean the Commodity Futures Trading Commission as well as its predecessor agencies, including the CEC.

speculative market activity. The Commission and its predecessors have directly set limits for futures and options contracts on certain agricultural commodities since 1938. Additionally, for approximately 20 years from 1981 until the Commodity Futures Modernization Act ("CFMA")[701] amended the CEA to substitute a core-principles-based, self-regulatory model for futures exchanges, Commission rules required exchanges to set position limits (or, in certain specified cases, position accountability levels) for futures and options contracts not subject to Commission-imposed limits.[702] Through amendments to the CEA over more than 75 years and a number of legislative reauthorizations, the Commission's basic authority to establish speculative position limits, now codified in CEA section 4a(a), has remained constant.[703]

The backdrop for this basic authority is a public record replete with Congressional and other official governmental investigations and reports — issued over more than 80 years — critical of the harm attributed to "excess speculation" in derivative markets. From the 1920s through 2009, a litany of official government investigations, hearings and reports document disruptive speculative behavior;[704] several of the earliest link the

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[701] Commodity Futures Modernization Act of 2000, Public Law 106-554, 114 Stat. 2763 (Dec. 21, 2000).

[702] See, e.g., 46 FR 50938, 50940, Oct. 16, 1981. As discussed above, following enactment of the CFMA, which among other things afforded DCMs discretion to set appropriate position limits under DCM core principle 5, these rules, then contained in § 150.5, became ineffective as requirements; they were retained, however, as guidance and acceptable practices for DCMs to use in meeting their core principle 5 compliance obligations. 74 FR 12178, 12183, Mar. 23, 2009.

[703] One of these amendments, the Commodity Futures Trading Act of 1974, created the CFTC and granted it expanded jurisdiction beyond the certain enumerated agricultural products of its predecessor to all "services, rights, and interests" in which futures contracts are traded. Pub. L. No. 93-463, 88 Stat. 1389 (1974).

[704] See, e.g., Federal Trade Commission, "Report of the Federal Trade Commission on the Grain Trade," vol. VI, at 60-62 (1924)(documenting a number of "violent fluctuations of price" over the preceding 30 years evidencing "the close connection between extreme fluctuations in annual average prices of cash grain and unusual speculative activity in the futures market"); id. vol. VII, at 293-294 (1926)(recommending limitation on individual open interest because the "very large trader … [w]hether he is more often right than wrong … and whether influenced by a desire to manipulate or not … can cause disturbances in the market which impair its proper functioning and are harmful to producers and consumers"); Grain Futures

behavior to artificial price effects and impaired commodity distribution efficiency, and recommend mandatory position limits as a tool to curb speculative abuses and their ill-effects. The statute reflects and responds to the centerpiece concern of these hearings and reports. Indeed, CEA section 4a(a)(1) states Congress's express determination that excessive commodity speculation causing sudden or unreasonable price fluctuations or unwarranted changes in commodity prices is an undue and unnecessary burden on interstate commerce, and mandates that the Commission set position limits, including prophylactic limits, to diminish, eliminate, or prevent this burden.[705]

Administration, "Fluctuations in Wheat Futures," S. Doc. No. 69-135, at 1,6 (1926) (investigation of "wide and erratic [1925 wheat futures] price fluctuations … were largely artificial[,] were caused primarily … by heavy trading on the part of a limited number of professional speculators [that] completely disrupted the market and resulted in abnormal fluctuations … felt in every other large grain market in the world;" concludes that limitations on the extent of daily trading by speculators are "inevitable … if there is to be eliminated from the market those hazards which are so unmistakably reflected as existing whenever excessively large lines are held by individuals"); 1932 Annual Report of the Chief of the Grain Futures Admin., at 4, 8 (describing the 16 percent drop in May wheat prices during a21-day period as illustrative of the price impact of "short selling by a few large traders;" again stresses the need for legislation authorizing limitations to eliminate "the economic evils incident to market domination by a few powerful operators trading for speculative account"); 1950 Annual Report of the Administrator of the Commodity Exchange Authority, at 14-15 (speculative operations by a small number of traders holding a large proportion of long contracts "distorted egg future prices in October 1949 and disrupted orderly marketing of the commodity causing financial losses;" notes that enforcement of speculative limits is a "strong deterrent to excessive speculation by large traders"); Commodity Futures Trading Commission, Report To The Congress In Response To Section 21 Of The Commodity Exchange Act, May 29, 1981, Part Two, A Study of the Silver Market (addressing silver market corner discussed above); "The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat," Staff Report, Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, U.S. Senate, S. Rpt. No. 109-65 at 1 (June 27, 2006) (addressing speculation and price increases in oil and gas markets) [hereinafter "Oil & Gas Report"]; "Excessive Speculation in the Natural Gas Market, Staff Report," Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, U.S. Senate, at 1 (June 25, 2007) (addressing speculation, price increases and market distortion in natural gas markets discussed above) [hereinafter "Gas Report"]; "Excessive Speculation in the Wheat Market;" Staff Report, Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs, U.S. Senate, at 2 (June 24, 2009) (addressing excessive speculation in wheat futures contracts by commodity index traders) [hereinafter "Wheat Report"]; see also Jerry W. Markham, "The History of Commodity Futures Trading and its Regulation," at 3-47 (1987) (summarizes numerous incidents of large speculative trader abuse in an array of commodities from the emergence of futures exchanges in the mid-1800s through the 1970s).

[705] The roots of this statutory determination date back to 1922, when Congress found "sudden or unreasonable fluctuations in the prices" of certain commodity futures transactions "frequently occur as a result of [ ] speculation, manipulation or control" and that "such fluctuations in prices are an obstruction to and a burden upon" interstate commerce. Grain Futures Act of 1922, ch. 369 at section 3, 342 Stat. 998, 999 (1922), codified at 7 U.S.C. 5 (1925-26).

The longstanding statutory approach to position limit regulation reflects two important concepts with direct bearing on the benefits and costs involved in this rulemaking. First is the distinction between speculative trading, for which limits are statutorily authorized, and, as to derivatives for physical commodities, mandated, and bona fide hedging, for which they are not.[706] This distinction is important because a chief purpose of position limits is to preserve the integrity of derivative markets for the benefit of producers that use them to hedge risk and consumers that consume the underlying commodities.

Second is the distinction between speculation generally and excessive speculation as addressed in CEA section 4a(a)(1). While, as noted above, numerous government inquires have linked speculation at excessive levels to abuses and burdens on commerce, below excessive levels, speculation provides needed liquidity to derivative markets.[707]

In 2010 the Dodd-Frank Act[708] amended CEA section 4a(a). These amendments responded to the 2008 financial crisis and came in the wake of three Congressional reports within a three-year span finding increased and/or "excessive" derivative market speculation linked to increased and distorted prices. These reports recommended increased statutory authority to, in the parlance of two of the reports, put the Commission "back on the beat." [709] Among other things, the Dodd-Frank Act[710] expanded the

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[706] See CEA section 4a(c)(1); 7 U.S.C. 6a(c)(1).

[707] Hedgers do not always trade simultaneously in the same quantities in opposing directions. That is, long and short hedgers may trade at different times and with different quantities, often making transactions between only hedgers unfeasible. Speculative traders thus provide a trading partner for hedgers for whom there is no feasible hedger counterparty. In so doing, speculators provide valuable liquidity to the market.

[708] Pub .L. No. 111-203, 124 Stat. 1376 (2010).

[709] See, e.g.,Wheat Report, at 15-16 (excessive speculation in wheat futures contracts by commodity index traders contributed to "unreasonable fluctuations or unwarranted changes" in wheat futures prices, resulting in an abnormally large and persistent gap between wheat futures and cash prices (the basis);" commerce was unduly burdened; stiffened position limit regulation for index traders recommended); Gas Report, at 3-

Commission's speculative position limit authority under CEA section 4a to mandate that the Commission: (i) establish limits on the amount of positions, as appropriate, that may be held by any person in agricultural and exempt commodity[711] futures and options contracts traded on a DCM (CEA section 4a(a)(2));[712] (ii) establish at an appropriate level position limits for swaps that are economically equivalent to those futures and options that are subject to mandatory position limits pursuant to CEA section 4a(a)(2), and do so at the same time as the CEA section 4a(a)(2) limits are established (CEA section 4a(a)(5)); and (iii) apply position limits on an aggregate basis to contracts based on the same underlying commodity across enumerated trading venues[713] (CEA section 4a(a)(6)).

Additionally, the Dodd-Frank Act requires DCMs and SEFs to set position limits for any contract subject to a Commission-imposed limit at a level not higher than the

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7 ("[t]he current regulatory system was unable to prevent [the hedge fund] Amaranth's excessive speculation in the 2006 natural gas market;" the experience demonstrated "how excessive speculation can distort prices" and have "serious consequences for other market participants;" and the Commission should be put "back on the beat"); Oil & Gas Report, at 6-7 (heavy speculation in commodity energy markets contributed to rising U.S. energy prices, distorting the historical relationship between price and inventory; recommends putting the CFTC "back on the beat" to police these markets by eliminating the "Enron" loophole that limited it from doing so). In the interval between the two reports addressed to energy market speculation and the Dodd-Frank Act amendments, Congress also expanded the Commission's authority to set position limits for significant price discovery contracts on exempt commercial markets. See Food, Conservation and Energy Act of 2008, Pub. L. No. 110–246, 122 Stat. 1624 (2008).

[710] Dodd-Frank Act section 737(a).

[711] As defined in CEA section 1a(20), "exempt commodity" means a commodity that is neither an agricultural commodity nor an "excluded commodity." Excluded commodities, in turn, are defined in CEA section 1a(19) to encompass specified groups of financial and occurrence-based commodities. Accordingly, exempt commodities include energy products and metals. The Dodd-Frank mandate in CEA section 4a(a)(2) to impose limits applies to all agricultural and exempt commodities (collectively, physical commodities). This mandate does not apply to excluded commodities, which are primarily intangible commodities, like financial products.

[712] The Commission's statutory interpretation of its mandate under CEA section 4a(a)(2) is discussed in detail above. A separate provision added by the Dodd-Frank Act directs the Commission with respect to factors to consider in establishing the levels of speculative position limits that are mandated by CEA section 4a(a)(2). See CEA section 4a(a)(3); 7 U.S.C. 6a(a)(3).

[713] Specifically, as enumerated these are: (1) contracts listed by DCMs; (2) with respect to FBOTs, contracts that are price-linked to a contract listed for trading on a registered entity and made available from within the United States via direct access; and (3) SPDF Swaps.

Commission's limit.[714] Finally, the Dodd-Frank Act, through new CEA section 4a(c)(2), requires that the Commission define bona fide hedging positions pursuant to an express framework for purposes of exclusion from position limits. The Commission's approach, historically, to exercising its statutory position limits authority has been to set or order limits prophylactically to deter all forms of manipulation and to diminish, eliminate, or prevent excessive speculation.[715] It has done so through regulations comprised of three primary components: (1) the level of the limits, which set a threshold that restricts the number of speculative positions that a person may hold in the spot-month, in any individual month, and in all months combined; (2) the standards for what constitute bona fide hedging versus speculative transactions, as well as other exemptions; and (3) the accounts and positions a person must aggregate for the purpose of determining compliance with the position limit levels. These rules now reside in part 150 of the Commission's regulations.[716] The rules proposed herein would amend part 150 and make certain conforming amendments to related reporting requirements in parts 15, 17 and 19. They would do so in a manner that represents an extension of the Commission's

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[714] See Dodd-Frank Act sections 735(b) (amending CEA section 5(d)(5)) and 733 (adding CEA section 5h, subsection (f)(6) of which specifies SEF's core principle obligation with respect to position limitations or accountability).

[715] See, e.g., 46 FR 50938, 50940, Oct. 16, 1981. In this release adopting § 1.61, the Commission articulated its interpretation that the CEA authorized prophylactic speculative position limits. One year later, Congress enacted the Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294, 2299-2300(1982), which, inter alia, amended the CEA to "clarify and strengthen the Commission's" position limits authority. S. Rep. 97-384, at 44 (1982). Congress enacted this strengthening amendment with awareness of the Commission's prophylactic interpretation and approach, and after rejecting amendments that would have circumscribed the Commission's authority. See, e.g., Futures Trading Act of 1982: Hearings on S. 2109 before the S. Subcomm. on Agricultural Research, 97th Cong. 28, 29, 44-45, 337, 340-45 (1982) (oral and written statements of Commission Chair Phillip McBride Johnson and Commodity Exchange Executive Vice Chair Lee Berendt concerning, inter alia, the Commission's omnibus approach to position limits); S. Rep. 97-384, at 44-45, 79 (discussing rejected amendments).

[716] As discussed above, the District Court for the District of Columbia vacated part 151 of the Commission's regulations, which would have replaced part 150. As a result, part 150 remains in effect.

historical approach towards the first two components: limit levels and exemptions. The third component, aggregation, is addressed in a separate Commission rulemaking.[717]

i. Statutory mandate to consider costs and benefits

CEA section 15(a)[718] requires the Commission to consider the costs and benefits of its actions before promulgating a regulation under the CEA or issuing certain orders. CEA section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations.[719]

The Commission considers the costs and benefits resulting from its discretionary determinations with respect to the CEA section 15(a) factors.

Accordingly, the discussion that follows identifies, and considers against the five CEA section 15(a) factors, benefits and costs to market participants and the public that the Commission expects to flow from these proposed rules relative to the statutory requirements of the CEA and the Commission's regulations now in effect. The Commission has attempted to quantify the costs and benefits of these regulations where feasible. Where quantification is not feasible the Commission identifies and considers costs and benefits qualitatively.

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[717] See Aggregation NPRM.

[718] 7 U.S.C. 19(a).

[719] In ICI v. CFTC, 2013 WL 3185090, at *8 (D.C. Cir. 2013), the United States Court of Appeals for the D.C. Circuit held that CEA section 15(a) imposes no duty on the Commission to conduct a quantitative economic analysis: "Where Congress has required "'rigorous, quantitative economic analysis,'" it has made that requirement clear in the agency's statute, but it imposed no such requirement here [in the CEA]." Id. (citation omitted).

Beyond specific questions interspersed throughout its discussion, the Commission generally requests comment on all aspects of its consideration of costs and benefits, including: identification and assessment of any costs and benefits not discussed therein; data and any other information to assist or otherwise inform the Commission's ability to quantify or qualify the benefits and costs of the proposed rules; and, substantiating data, statistics, and any other information to support positions posited by commenters with respect to the Commission's consideration of costs and benefits.

The following consideration of benefits and costs is generally organized according to the following rules proposed in this release: definitions (§ 150.1),[720] federal position limits (§ 150.2), exemptions to limits (§ 150.3), position limits set by DCMs and SEFs (§ 150.5), anticipatory hedging requirements (§ 150.7), and reporting requirements (§ 19.00). For each rule, the Commission summarizes the proposed rule and considers the benefits and costs expected to result from it.[721] The Commission then considers the benefits and costs of the proposed rules collectively in light of the five public interest considerations of CEA section 15(a).

2. <u>Section 150.1 – Definitions</u>

Currently, § 150.1 defines terms for operation within the various rules that comprise part 150. As described above, the Commission proposes formatting, organizational, and other non-substantive amendments to these definitional provisions that, subject to consideration of any relevant comments, it does not view as having

[720] Many of the revised or new definitions do not substantively affect the Commission's considerations of costs and benefits on their own merit, but are considered in conjunction with the sections of the rule that implement them.

[721] The proposed rules also include amendments to 17 CFR parts 15 and 17, as discussed <u>supra</u>. The Commission preliminarily believes these amendments are not substantive in nature and do not have cost or benefit implications. The Commission welcomes comment on any potential costs or benefits of the changes to parts 15 and 17.

benefit or cost implications.[722] But, with respect to a number of definitions, the Commission proposes substantive amendments and additions. With the exception of the term "bona fide hedging position," for which the benefits and costs of the proposed § 150.1 definition are considered in the subsection directly below, any benefits and costs attributable to substantive definitional changes and additions proposed in §150.1 are considered in the discussion of the rule in which such new or amended terms would be operational.

i. Bona fide hedging

Proposed §150.1 would include a definition of the term "bona fide hedging positions" — which operates to distinguish hedging positions from those that are speculative and thus subject to position limits, both federal and exchange-set, unless otherwise exempted by the Commission. Hedgers present a lesser risk of burdening interstate commerce as described in CEA section 4a because their positions are offset in the physical market. CEA section 4a(c) has long directed that no Commission rule, regulation or order establishing position limits under CEA section 4a(a) apply to bona fide hedging as defined by the Commission.[723] The proposed definition would replace the definition now contained in § 1.3(z) to implement that statutory directive.[724]

Generally, the current definition of bona fide hedging in § 1.3(z) advises that a position should "normally represent a substitute for … positions to be taken at a later

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[722] See supra discussion of proposed amendments to § 150.1.

[723] CEA section 4a(c)(1); 7 U.S.C. 6a(c)(1).

[724] Currently, 17 CFR 1.3(z), defines the term "bona fide hedging transactions and positions." Originally adopted by the newly formed Commission in 1975, a revised version of § 1.3(z) took effect two years later. This 1977 revision largely forms the basis of the current definition of bona fide hedging. A history of the definition of bona fide hedging is presented above. With the adoption of the proposed definition of "bona fide hedging positions" in § 150.1, § 1.3(z) would be deleted.

time in a physical marketing channel" and requires such position to be "economically appropriate to the reduction of risks in the conduct of a commercial enterprise" where the risks arise from the potential change in value of assets, liabilities, or services.[725] Such bona fide hedges must have a purpose "to offset price risks incidental to commercial cash or spot operations" and must be "established and liquidated in an orderly manner in accordance with sound commercial practices."

This general definition thus provides general components of the type of position that constitute a bona fide hedge position. The criterion that such a position should "normally represent a substitute for … positions to be taken at a later time in a physical marketing channel" has been deemed the "temporary substitute" criterion. The requirement that such position be "economically appropriate to the reduction of risks in the conduct of a commercial enterprise" is referred to as the "economically appropriate" test. The criterion that hedged risks arise from the potential change in value of assets, liabilities, or services is commonly known as the "change in value" requirement or test. The phrase "price risks incidental to commercial cash or spot operations" has been termed the "incidental test." The criterion that hedges must be "established and liquidated in an orderly manner" is known as the "orderly trading requirement."[726]

The current definition also describes a non-exclusive list of transactions that satisfy the definitional criteria and therefore qualify as bona fide hedges; these "enumerated hedging transactions" are located in § 1.3(z)(2). For those transactions that

[725] 17 CFR 1.3(z)(1). The Commission cautions that the e-CFR 2012 version of this provision reflects changes made by the now-vacated Part 151 rule.

[726] See supra for additional explanation of these terms.

may fit the definition but are not listed in § 1.3(z)(2), current § 1.3(z)(3) provides a means of requesting relief from the Commission.

The Dodd-Frank Act amended the CEA in ways that require the Commission to adjust its current bona fide hedging definition. Specifically, the Dodd-Frank Act added section 4a(c)(2) of the Act, which the Commission interprets as directing the Commission to narrow the bona fide hedging position definition for physical commodities from the definition found in current § 1.3(z)(1).[727]

Dodd-Frank also provided direction regarding the bona fide hedging criteria for swaps contracts newly under the Commission's jurisdiction. Specifically, new CEA sections 4a(a)(5) and (6) require the Commission to impose limits on an aggregate basis across all economically equivalent contracts, excepting in both cases bona fide hedging positions. CEA section 4a(c)(2)(B) describes which swap offset positions may qualify as bona fide hedges. Finally, new CEA section 4a(a)(7) provides the Commission with authority to grant exemptive relief from position limits. The Commission proposes to amend its definition of bona fide hedging under the authority and direction of amended CEA section 4a(c) and the other provisions added by the Dodd-Frank Act. To the extent a change in the definition represents a statutory requirement, it is not discretionary and thus not subject to CEA section 15(a).

ii. <u>Rule summary</u>

Like current § 1.3(z), the proposed § 150.1 bona fide hedging definition employs a basic organizational model of stating general, broadly applicable requirements for a

hedge to qualify as bona fide,[728] and then specifying certain particular ("enumerated") hedges that are deemed to meet the general requirements.[729] Generally, the proposed definition is built around the same criteria as are currently found in § 1.3(z), including the temporary substitute and economically appropriate criteria. Thus, the proposed definition is substantially similar to the current definition, with limited changes to accommodate altered statutory requirements regarding bona fide hedging as well as accomplish discretionary improvements. The proposed definition also reflects organizational changes to better accommodate the extension of speculative position limits to all economically equivalent contracts across all trading venues. To the extent the proposed definition carries over requirements currently resident in the §1.3(z) definition, it does not represent a change from current practice and therefore should not pose incremental benefits or costs.

The proposed definition has been relocated from § 1.3(z) to § 150.1 in order to facilitate reference between sections of part 150. The proposed definition of bona fide hedging position is also re-organized into six sections, starting with an opening paragraph describing the general requirements for all hedges followed by five numbered paragraphs. Paragraph (1) of the proposed definition describes requirements for hedges of an excluded commodity,[730] including guidance on risk management exemptions that may be adopted by an exchange. Paragraph (2) describes requirements for hedges of a physical

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[728] Compare 17 CFR 1.3(z)(1) ("General Definition") with the proposed § 150.1 definition of bona fide hedging opening sentence and paragraphs (1) and (2) (respectively, "Hedges of an excluded commodity" and "Hedges of a physical commodity").

[729] Compare 17 CFR 1.3(z)(2)("Enumerated Hedging Transactions") with the proposed § 150.1 definition of bona fide hedging paragraphs (3)and (4) (respectively, "Enumerated hedging positions" and "Other enumerated hedging positions").

[730] An "excluded commodity" is defined in CEA section 1a(19). The definition includes financial products such as interest rates, exchange rates, currencies, securities, credit risks, and debt instruments as well as financial events or occurrences.

commodity. Paragraphs (3) and (4) describe enumerated exemptions. Paragraph (5) describes cross-commodity hedges.

The following discussion is meant to highlight the essential components of each section of the proposed definition. A full discussion of the history and policy rationale of each section may be found supra.[731]

a. Opening paragraph

The opening paragraph of the proposed definition incorporates the incidental test and the orderly trading requirement, both found in the current § 1.3(z)(1). The Commission intends the proposed incidental test to be a requirement that the risks offset by a commodity derivative contract hedging position must arise from commercial cash market activities. The Commission believes this requirement is consistent with the statutory guidance to define bona fide hedging positions to permit the hedging of "legitimate anticipated business needs."[732] The incidental test allows the Commission to distinguish between hedging and speculate activities by defining the former as requiring a legitimate business need.

The proposed orderly trading requirement is intended to impose on bona fide hedgers the duty to enter and exit the market carefully in the ordinary course of business. The requirement is also intended to avoid to the extent possible the potential for significant market impact in establishing or liquidating a position in excess of position limits. This requirement is particularly important because, as discussed below, the Commission proposes to set the initial levels of position limits at the outer bound of the range of levels of limits that may serve to balance the statutory policy objectives in CEA

[731] See discussion above.

[732] 7 U.S.C. 6a(c)(1).

section 4a(a)(3) for limit levels. As such, bona fide hedgers likely would only need an exemption for very large positions. The orderly trading requirement is intended to prevent disorderly trading, practices, or conduct from bona fide hedgers by encouraging market participants to assess market conditions and consider how the trading practices and conduct affect the orderly execution of transactions when establishing or liquidating a position greater than the applicable position limit.[733]

b. Paragraph (1) hedges of an excluded commodity

The first paragraph in the proposed definition addresses hedging of an excluded commodity; it emanates from the Commission's discretionary authority to impose limits on intangible commodities. In general, in addition to the requirements in the opening paragraph, proposed paragraph (1) requires the position meet the economically appropriate test and is either enumerated in paragraphs (3), (4), or (5) of the proposed definition or is recognized by a DCM or SEF as a bona fide hedge pursuant to exchange rules. The temporary substitute and change in value criteria are not included in the proposed paragraph (1), as these requirements are inappropriate in the context of certain excluded commodities that lack a physical marketing channel.[734]

Exclusively addressed to excluded commodity hedging, paragraph (1) is relevant only for the purposes of exchange-set limits under § 150.5 as proposed for amendment. As the Commission has determined to focus the application of federal speculative position limits on 28 physical commodities and their related physical-delivery and cash-

[733] As discussed supra, the Commission believes that negligent trading, practices, or conduct should be a sufficient basis for the Commission to deny or revoke a bona fide hedging exemption.

[734] The Commission notes that DCMs currently incorporate the temporary substitute and change in value criteria when the contract's underlying market has physical delivery obligations. The proposal would not limit their ability to continue to do so when appropriate.

settled referenced contracts, this paragraph does not affect the imposition of federal speculative position limits and exemptions thereto.

c. Paragraph (2) Hedges of a Physical Commodity

Proposed paragraph (2) of the definition enumerates what constitutes a hedge for physical commodities, including physical agricultural and exempt commodities both subject and not subject to federal speculative position limits. In addition to the requirements in the opening paragraph, proposed paragraph (2) requires that the position satisfy the temporary substitute test, the economically appropriate test, and the change-in-value test. These tests have been incorporated into the revised statutory definition in CEA section 4a(c)(2) and essentially mirror the current definition in § 1.3(z).[735] The proposed paragraph (2) also requires the position either be enumerated in proposed paragraphs (3), (4), or (5) or be a pass-through swap offset or pass-through swap position as defined in paragraph (2)(ii).

Proposed paragraph (2) of the definition applies generally to derivative positions that hedge a physical commodity and as such includes swaps. Thus, the paragraph responds to the statutory requirement in CEA section 4a(a)(5) that the Commission establish limits on economically equivalent contracts, including swaps, excluding bona fide hedging positions. The definition of a pass-through swap offset position incorporates the definition in new CEA section 4a(c)(2)(B)(i), with the inclusion of the requirement that such position not be maintained during the lesser of the last five days of trading or the time period for the spot month for the physical-delivery contract.

d. Paragraphs (3) and (4) Enumerated Hedging Positions

[735] With respect to the temporary substitute test, the word "normally" has been removed in the proposed definition in order to conform with the stricter statutory standard in new CEA section 4a(c)(2). See discussion above.

Proposed paragraph (3) lists specific positions that would fit under the definition of a bona fide hedging position, including hedges of inventory, cash commodity purchase and sales contracts, unfilled anticipated requirements, and hedges by agents.[736] Each of these positions was described in § 1.3(z), with the exception of paragraph (iii)(B), which was added in response to the petition submitted to the Commission by the Working Group of Commercial Energy Firms.[737]

Proposed paragraph (4) provides other enumerated hedging exemptions, including hedges of unanticipated production, offsetting unfixed price cash commodity sales and purchases, anticipated royalties, and services, all of which are subject to the "five-day rule." The "five-day rule" is a provision in many of the enumerated hedging positions that prohibits a trader from maintaining the positions in any physical-delivery commodity derivative contract during the lesser of the last five days of trading or the time period for the spot month in such physical-delivery contract.[738] Because each exemption shares this provision, the Commission is proposing to reorganize such exemptions into proposed paragraph (4) for administrative efficiency.

Of the enumerated hedges in proposed paragraphs (4)(i) and (ii) are currently in § 1.3(z) and paragraph (4)(iv) codifies a hedge that has historically been recognized by the Commission. Paragraph (4)(iii) proposes a royalties exemption not now specified in § 1.3(z).

e. <u>Paragraph (5) cross-commodity hedges</u>

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[736] A detailed description of each enumerated position can be found <u>supra</u>.

[737] <u>See</u> discussion above.

[738] As discussed <u>above</u>, the purpose of the five-day rule is to protect the integrity of the delivery and settlement processes in physical-delivery contracts. Without this rule, high concentrations of exempted positions can distort the markets, impairing price discovery while potentially having an adverse impact on efforts to deter all forms of market manipulation and diminish excessive speculation.

Proposed paragraph (5) describes positions that would qualify as cross-commodity bona fide hedges. The Commission has long recognized cross-commodity hedging, stating in 1977 that such positions would be covered under the general provisions of § 1.3(z)(2).

The definition in proposed paragraph (5) would condition cross-commodity hedging on: (i) whether the fluctuations in value of the position in the commodity derivative contract are "substantially related" to the fluctuations in value of the actual or anticipated cash position or pass-through swap; and (ii) the five-day rule being applied to positions in any physical-delivery commodity derivative contract. The second condition, i.e. the application of the five-day rule, would help to protect the integrity of the delivery process in the physical-delivery contract but would not apply to cash-settled contract positions.[739]

iii. Benefits and costs

Elements of the proposed definition that represent discretionary, substantive modifications to the required manner in which bona fide hedging have been defined under §1.3(z) include the following:[740] (i) proposing requirements for hedges in an excluded commodity in proposed paragraph (1); (ii) adding the five-day rule into the statutory definition of pass-through swap as described in paragraph (2)(ii)(A); (iii) applying the definition in proposed paragraph (2) to positions in economically equivalent

[739] See discussion above.

[740] The Commission notes that the relocation of the definition from § 1.3(z) to part 150 is also discretionary. As noted above, the placement is intended to facilitate compliance with the other sections of part 150; the Commission does not believe, however, that this action has substantive cost or benefit implications. Also, the proposed definition incorporates and references elements of non-binding guidance not encompassed by CEA section 15(a).

contracts in a physical commodity;[741] (iv) expanding paragraph (3)(III)(b) to incorporate hedges encouraged by a public utility commission; (v) expanding paragraph (4)(ii) to include offsetting unfixed-price cash commodity sales and purchases that are basis different contracts in the same commodity, regardless of whether the contracts are in the same calendar month; (vi) adding paragraph (iii) to proposed paragraph (4) to enumerate anticipated royalty hedges; and (vii) enumerating cross-commodity hedges as a standalone provision in paragraph (5).

a. Benefits

The Commission proposes the definition for excluded commodities in paragraph (1) in order to provide a consistent definition of bona fide hedging — i.e., a definition that incorporates the economically appropriate test — for all commodities under the Commission's jurisdiction. The addition of paragraph (1) would provide exchanges with a definition for bona fide hedging designed to provide a level of assurance that the Commission's policy objectives regarding bona fide hedging are met at the exchange level as well as at the federal level, and for excluded commodities as well as agricultural and exempt commodities.

The Commission believes that the additions to the definition of bona fide hedging proposed in this release provide additional necessary relief to bona fide hedgers. This relief, in turn, will help to ensure that market participants with positions hedging legitimate business needs are properly recognized as hedgers under the Commission's

[741] As discussed supra, CEA section 4a(a)(5) requires that the Commission set speculative limits on the amount of positions, "other than bona fide hedging positions … held by any person with respects to swaps that are economically equivalent" to futures and options. 7 U.S.C. 6a(a)(5). Subject to CEA section 4a(a)(2), the Commission is exercising its discretion in defining bona fide hedging in economically equivalent contracts in the same manner as for futures and options in physical commodities. 7 U.S.C. 6a(a)(2).

speculative position limits regime. Thus, the Commission anticipates that the addition of the enumerated position for anticipated royalties and the expansion of the enumerated unfilled anticipated requirements position provide additional means for obtaining a hedge exemption by recognizing the legitimate business need in each position. The safe harbor proposed in paragraph (5) is expected to provide clarity and promote regulatory certainty for entities that use cross-commodity hedging strategies. Further, the addition of the five-day rule to the hedging definition for pass-through swaps helps the Commission to ensure the integrity of the delivery process in the physical-delivery contract and as a result to accomplish to the maximum extent practicable the factors in CEA section 4a(a)(3). Finally, the Commission believes using the same bona fide hedging exemptions in economically equivalent contracts may facilitate administrative efficiency by avoiding the need for market participants to manage and apply different definitional criteria across multiple products and trading venues.[742] The Commission requests comment on its consideration of the benefits of the proposed definition of bona fide hedging. Has the Commission misidentified any of the benefits of the proposed rule? Are there additional benefits the Commission ought to consider regarding the proposed definition of bona fide hedging? Why or why not?

b. Costs

The Commission anticipates that there will be some small additional costs associated with the proposed definition.

[742] Further, using the same exemptions in economically equivalent contracts is consistent with the approach of the Dodd-Frank Act section 737(a) amendment requiring that the Commission establish limits for economically equivalent swap positions and across trading venues, including direct-access linked FBOT contracts. See 7 U.S.C. 6a(a)(5)-(6).

Entities may incur costs to the extent the proposed definition of a bona fide hedging position in an excluded commodity requires an exchange to adjust its policies for bona fide hedging exemptions or a market participant to adjust its trading strategies for what is and is not a bona fide hedge in an excluded commodity. The Commission expects such costs to be negligible, as the definition is substantially the same as the current definition under § 1.3(z). Costs for exchanges are also considered in the section of this release that discusses the proposed amendments to § 150.5.

In general, under other aspects of the Commission's proposed definition, market participants may incur costs to determine whether their positions fall under one of the new or expanded enumerated positions. In the event a position does not fit under any of the enumerated positions, market participants may incur costs associated with filing for exemptive relief as described in the section discussing the costs of proposed § 150.3 or in altering speculative trading strategies as discussed above. As trading strategies are proprietary, and the determinations made by individual entities present a burden that is highly idiosyncratic, it is not reasonably feasible for the Commission to estimate the value of the burden imposed.

c. <u>Request for comment</u>

The Commission requests comment on its consideration of the costs of the proposed definition of bona fide hedging position. Are there additional costs related to the Commission's discretionary actions that the Commission should consider? Has the Commission misidentified any costs? Commenters are encouraged to submit any data that the Commission should consider in evaluating the costs of the proposed definition.

d. <u>Consideration of alternatives</u>

The Commission recognizes that alternatives exist to discretionary elements of the definition of bona fide hedging positions proposed herein. The Commission requests comments on whether an alternative to what is proposed would result in a superior benefit-cost profile, with support for any such position provided.

3. Section 150.2 – Limits

i. Rule summary

As previously discussed, the Commission interprets CEA section 4a(a)(2) to mandate that it establish speculative position limits for all agricultural and exempt physical commodity derivative contracts.[743] The Commission currently sets and enforces speculative position limits for futures and futures-equivalent options contracts on nine agricultural products. Specifically, current § 150.2 provides "[n]o person may hold or control positions, separately or in combination, net long or net short, for the purchase or sale of a commodity for future delivery or, on a futures-equivalent basis, options thereon, in excess of" enumerated spot, single-month, and all-month levels for nine specified contracts.[744] These proposed amendments to § 150.2 would expand the scope of federal position limits regulation in three chief ways: (1) specify limits on 19 contracts in addition to the nine existing legacy contracts (i.e., a total of 28); (2) extend the application of these limits beyond futures and futures-equivalent options to all commodity derivative interests, including swaps; and (3) extend the application of these limits across trading venues to all economically equivalent contracts that are based on the

[743] See supra discussion of the Commission's interpretation of this mandate.

[744] These contracts are Chicago Board of Trade corn and mini-corn, oats, soybeans and mini-soybeans, wheat and mini-wheat, soybean oil, and soybean meal; Minneapolis Grain Exchange hard red spring wheat; ICE Futures U.S. cotton No. 2; and Kansas City Board of Trade hard winter wheat.

same underlying commodity. In addition, the proposed rule would provide a methodology and procedures for implementing and applying the expanded limits.

The Commission proposes to amend § 150.2 to impose speculative position limits as mandated by Congress in accordance with the statutory bounds that define its discretion in doing so. First, pursuant to CEA section 4a(a)(5) the Commission must concurrently impose position limits on swaps that are economically equivalent to the agricultural and exempt commodity derivatives for which position limits are mandated in section 4a(a)(2). Second, CEA section 4a(a)(3) requires that the Commission appropriately set limit levels mandated under section 4a(a)(2) that "to the maximum extent practicable, in its discretion," accomplish four specific objectives.[745] Third, CEA section 4a(a)(2)(C) requires that in setting limits mandated under section 4a(a)(2)(A), the "Commission shall strive to ensure that trading on foreign boards of trade in the same commodity will be subject to comparable limits and that any limits … imposed … will not cause price discovery in the commodity to shift to trading on the foreign boards of trade." Key elements of the proposed rule are summarized below.[746]

Generally, proposed § 150.2 would limit the size of speculative positions,[747] i.e., prohibit any person from holding or controlling net long/short positions above certain specified spot month, single month, and all-months-combined position limits. These

[745] These objectives are to: (1) "diminish, eliminate, or prevent excessive speculation;" (2) "deter and prevent market manipulation, squeezes, and corners;" (3) "ensure sufficient market liquidity for bona fide hedgers;" and (4) "ensure that the price discovery function of the underlying market is not disrupted." 7 U.S.C. 6a(a)(3).

[746] For a more detailed description, see discussion above.

[747] Proposed § 150.1 would include a consistent definition of the term "speculative position limits."

position limits would reach: (1) 28 "core referenced futures contracts,"[748] representing an expansion of 19 contracts beyond the 9 legacy agricultural contracts identified currently in § 150.2;[749] (2) a newly defined category of "referenced contracts" (as defined in proposed § 150.1);[750] and (3) across all trading venues to all economically equivalent contracts that are based on the same underlying commodity.

a. § 150.2(a) spot-month speculative position limits

In order to implement the statutory directive in CEA section 4a(a)(3)(A), proposed § 150.2(a) would prohibit any person from holding or controlling positions in referenced contracts in the spot month in excess of the level specified by the Commission for referenced contracts.[751] Proposed § 150.2(a) would require, in the Commission's discretion, that a trader's positions, net long or net short, in the physical-delivery

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[748] Proposed § 150.1 also would define the term "core referenced futures contract" by reference to "a futures contract that is listed in § 150.2(d)."

[749] Specifically, in addition to the existing 9 legacy agricultural contracts now within § 150.2 — i.e., Chicago Board of Trade corn, oats, soybeans, soybean oil, soybean meal, and wheat; Minneapolis Grain Exchange hard red spring wheat; ICE Futures U.S. cotton No. 2; and Kansas City Board of Trade hard winter wheat — proposed § 150.2 would expand the list of core referenced futures contracts to capture the following additional agricultural, energy, and metal contracts: Chicago Board of Trade Rough Rice; ICE Futures U.S. Cocoa, Coffee C, FCOJ–A, Sugar No. 11 and Sugar No. 16; Chicago Mercantile Exchange Feeder Cattle, Lean Hog, Live Cattle and Class III Milk; Commodity Exchange, Inc., Gold, Silver and Copper; and New York Mercantile Exchange Palladium, Platinum, Light Sweet Crude Oil, NY Harbor ULSD, RBOB Gasoline and Henry Hub Natural Gas.

[750] This would result in the application of prescribed position limits to a number of contract types with prices that are or should be closely correlated to the prices of the 28 core referenced futures contracts — i.e., economically equivalent contracts — including: (1) "look-alike" contracts (i.e., those that settle off of the core referenced futures contract and contracts that are based on the same commodity for the same delivery location as the core referenced futures contract); (2) contracts based on an index comprised of one or more prices for the same delivery location and in the same or substantially the same commodity underlying a core referenced futures contract; and (3) inter-commodity spreads with two components, one or both of which are referenced contracts. The proposed "reference contract" definition would exclude, however, a guarantee of a swap.

[751] As discussed supra, the Commission proposes to adopt a streamlined, amended definition of "spot month" in proposed § 150.1. The term would be defined as the trading period immediately preceding the delivery period for a physical-delivery futures contract and cash-settled swaps and futures contracts that are linked to the physical-delivery contract. The definition proposes similar but slightly different language for cash-settled contracts, providing for the spot month to be the earlier of the period in which the underlying cash-settlement price is calculated or the close of trading on the trading day preceding the third-to-last trading day, until the contract cash-settlement price is determined. For more details, see discussion above.

referenced contract and cash-settled referenced contract be calculated separately under the spot month position limits fixed by the Commission for each. As a result, a trader could hold positions up to the applicable spot month limit in the physical-delivery contracts, as well as positions up to the applicable spot month limit in cash-settled contracts (i.e., cash-settled futures and swaps), but would not be able to net across physical-delivery and cash-settled contracts in the spot month.

b. § 150.2(b) single-month and all-months-combined speculative position limits

Proposed § 150.2(b) would provide that no person may hold or control positions, net long or net short, in referenced contracts in a single-month or in all-months-combined in excess of the levels specified by the Commission. Proposed § 150.2(b) would require netting all positions in referenced contracts (regardless of whether such referenced contracts are physical-delivery or cash-settled) when calculating a trader's positions for purposes of the proposed single-month or all-months-combined position limits (collectively "non-spot-month" limits).[752]

c. § 150.2(d) core referenced futures contracts

To be clear, the statutory mandate in Dodd-Frank section 4a(a)(2) applies on its face to all physical commodity contracts. The Commission is nevertheless proposing, initially, to apply speculative position limits to referenced contracts that are based on 28 core referenced futures contract listed in proposed § 150.2(d). As defined in proposed § 150.1, referenced contracts are futures, options, or swaps contracts that are directly or

[752] The Commission proposes to use the same level for single-month and all-months-combined limits, and refers to those limits as the "non-spot-month limits." The spot month and any single month refer to those periods of the core referenced futures contract.

indirectly linked to a core referenced futures contract or the commodity underlying a core referenced futures contract.[753]

Proposed § 150.2(d) lists the 28 core referenced futures contracts on which the Commission is initially proposing to establish federal speculative position limits. The list represents a significant expansion of federal speculative position limits from the current list of nine agricultural contracts under current part 150.[754] The Commission has selected these important food, energy, and metals contracts on the basis that such contracts (i) have high levels of open interest and significant notional value and/or (ii) serve as a reference price for a significant number of cash market transactions. Thus, the Commission is proposing limits to commence the expansion of its federal position limit regime with those commodity derivative contracts that it believes are likely to have the greatest impact on interstate commerce. Because the mandate applies to all physical commodity contracts, the Commission intends through supplemental rulemaking to establish limits for all other physical commodity contracts. Given limited Commission resources, it cannot do so in this initial rulemaking.

As discussed above,[755] the Commission calculated the notional value of open interest (delta-adjusted) and open interest (delta-adjusted) for all futures, futures options, and significant price discovery contracts as of December 31, 2012 in all agricultural and exempt commodities in order to select the list of 28 core referenced futures contracts in proposed § 150.2(d). The Commission selected commodities in which the derivative contracts had largest notional value of open interest and open interest for three categories:

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[753] As discussed above, the definition of referenced contract excludes any guarantee of a swap, basis contracts, and commodity index contracts.

[754] 17 CFR 150.2.

[755] See discussion above.

agricultural, energy, and metals. The Commission then designated the benchmark futures contracts for each commodity as the core referenced futures contracts for which position limits would be established. Proposed § 150.2(d) lists 19 core referenced futures contracts for agricultural commodities, four core referenced futures contracts for energy commodities, and five core referenced futures contracts for metals commodities.

d. § 150.2(e) levels of speculative position limits

The Commission proposes setting initial spot month position limit levels for referenced contracts at the existing DCM-set levels for the core referenced futures contracts. Thereafter, proposed § 150.2(e)(3) would task the Commission with recalibrating spot month position limit levels no less frequently than every two calendar years. The Commission's proposed recalibration would result in limits no greater than one-quarter (25 percent) of the estimated spot-month deliverable supply [756] in the relevant core referenced futures contract. This formula is consistent with the acceptable practices in current § 150.5, as well as the Commission's longstanding practice of using this measure of deliverable supply to evaluate whether DCM-set spot-month limits are in compliance with DCM core principles 3 and 5. The proposed rules separately restrict the size of positions in cash-settled referenced contracts that would potentially benefit from a trader's potential distortion of the price of the underlying core referenced futures contract.

[756] The guidance for meeting DCM core principle 3 (as listed in 17 CFR part 38 app. C) specifies that, "[t]he specified terms and conditions [of a futures contract], considered as a whole, should result in a 'deliverable supply' that is sufficient to ensure that the contract is not susceptible to price manipulation or distortion. In general, the term 'deliverable supply' means the quantity of the commodity meeting the contract's delivery specifications that reasonably can be expected to be readily available to short traders and salable by long traders at its market value in normal cash marketing channels. . ." See 77 FR 36612, 36722, Jun. 19, 2012.

As proposed, each DCM would be required to supply the Commission with an estimated spot-month deliverable supply figure that the Commission would use to recalibrate spot-month position limits unless it decides to rely on its own estimate of deliverable supply instead.[757]

In contrast to spot-month limits, which would be set as a function of deliverable supply, the proposed formula for the non-spot-month position limits is based on total open interest for all referenced contracts that are aggregated with a particular core referenced contract. Proposed § 150.2(e)(4) explains that the Commission would calculate non-spot-month position limit levels based on the following formula: 10 percent of the largest annual average open interest for the first 25,000 contracts and 2.5 percent of the open interest thereafter.[758] As is the case with spot month limits, the Commission proposes to adjust single month and all-months-combined limits no less frequently than every two calendar years.

The Commission's proposed average open interest calculation would be computed for each of the past two calendar years, using either month-end open contracts or open contracts for each business day in the time period, as practical and in the Commission's discretion. Initially, the Commission proposes to set the levels of initial non-spot-month limits using open interest for calendar years 2011 and 2012 in futures contracts, options thereon, and in swaps that are significant price discovery contracts and are traded on exempt commercial markets. Using the 2011/2012 combined levels of open

[757] Proposed § 150.2(e)(3)(ii) would require DCMs to submit estimates of deliverable supply. DCM estimates of deliverable supplies (and the supporting data and analysis) would continue to be subject to Commission review.

[758] Since 1999, the same 10 percent/2.5 percent methodology, now incorporated in current § 150.5(c)(2), has been used to determine futures all-months position limits for referenced contracts.

interest for futures contracts and for swaps that are significant price discovery contracts and are traded on exempt commercial markets will result in non-spot month position limit levels that are not overly restrictive at the outset; this is intended to facilitate the transition to the new position limits regime without disrupting liquidity. For example, the Commission is proposing a non-spot-month limit for CBOT Wheat that represents the harvest from around 2 million acres (3,125 square miles) of wheat, or 81 million bushels. The proposed non-spot-month limit for NYMEX WTI Light Sweet Crude Oil represents 109.2 million barrels of oil. The Commission believes these levels to be sufficiently high as to restrict excessive speculation without restricting the benefits of speculative activity, including liquidity provision for bona fide hedgers.

After the initial non-spot-month limits are set, the Commission proposes subsequently to use the data reported by DCMs and SEFs pursuant to parts 16, 20, and/or 45 to estimate average open interest in referenced contracts.[759]

e. § 150.2(f)-(g) pre-existing positions and positions on foreign boards of trade

The Commission proposes in new § 150.2(f)(2) to exempt from federal non-spot-month speculative position limits any referenced contract position acquired by a person in good faith prior to the effective date of such limit, provided that the pre-existing position is attributed to the person if such person's position is increased after the effective date of such limit.[760]

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[759] Options listed on DCMs would be adjusted using an option delta reported to the Commission pursuant to 17 CFR part 16; swaps would be counted on a futures equivalent basis, equal to the economically equivalent amount of core referenced futures contracts reported pursuant to 17 CFR part 20 or as calculated by the Commission using swap data collected pursuant to 17 CFR part 45.

[760] See also the definition of the term "Pre-existing position" incorporated in proposed § 150.1 herein. Such pre-existing positions that are in excess of the proposed position limits would not cause the trader to be in violation based solely on those positions. To the extent a trader's pre-existing positions would cause the trader to exceed the non-spot-month limit, the trader could not increase the directional position that caused the positions to exceed the limit until the trader reduces the positions to below the position limit. As

Finally, proposed § 150.2(g) would apply position limits to positions on foreign boards of trade ("FBOT"s) provided that positions are held in referenced contracts that settle to a referenced contract and that the FBOT allows direct access to its trading system for participants located in the United States.

ii. Benefits

The criteria set out in CEA section 4a(a)(3)(B) — namely, that position limit levels (1) "diminish, eliminate, or prevent excessive speculation;" (2) "deter and prevent market manipulation, squeezes, and corners;" (3) "ensure sufficient market liquidity for bona fide hedgers;" and (4) "ensure that the price discovery function of the underlying market is not disrupted" — clearly articulate objectives that Congress intended the Commission to accomplish, to the maximum extent practicable, in setting limit levels in accordance with the mandate to impose limits. The Commission is proposing to expand its speculative position limits regime to include all commodity derivative interests, including swaps; to impose federal limits on 19 additional contract markets; and to apply limits across trading venues to all economically equivalent contracts that are based on the same underlying commodity.

In so doing, the proposed rules generally would expand the prophylactic protections of federal position limits to additional contract markets. Proposed § 150.2(f) and (g) implement statutory directives in CEA section 4a(b)(2) and CEA section 4a(a)(6)(B), respectively, and are not acts of the Commission's discretion. Thus, the Commission is not required to consider costs and benefits of these provisions under CEA

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such, persons who established a net position below the speculative limit prior to the enactment of a regulation would be permitted to acquire new positions, but the total size of the pre-existing and new positions may not exceed the applicable limit.

section 15(a). Specific discussion of the benefits of the other components of proposed § 150.2 is below.

a. § 150.2(a) spot-month speculative position limits

As discussed above, CEA section 4a(a)(3)(A) now directs the Commission to set limits on speculative positions during the spot-month.[761] It is during the spot-month period that concerns regarding certain manipulative behaviors, such as corners and squeezes, become most urgent.[762] Spot-month position limits cap speculative traders' positions, and therefore restrict their ability to amass market power. In so doing, spot-month limits restrict the ability of speculators to engage in corners and squeezes and other forms of manipulation. They also prevent the potential adverse impacts of unduly large positions even in the absence of manipulation, thereby promoting a more orderly liquidation process for each contract.

The Commission has used its discretion in the manner in which it implements the statutorily-required spot-month position limits so as to achieve Congress's objectives in CEA section 4a(a)(3)(B)(ii) to prevent or deter market manipulation, including corners and squeezes. For example, the Commission has used its discretion under CEA section 4a(a)(1) to set separate but equal limits in the spot-month for physical-delivery and cash-settled referenced contracts. By setting separate limits for physical-delivery and cash-settled referenced contracts, the proposed rule restricts the size of the position a trader may hold or control in cash-settled reference contracts, thus reducing the incentive of a trader to manipulate the settlement of the physical-delivery contract in order to benefit positions in the cash-settled reference contract. Thus, the separate limits further enhance

[761] 7 U.S.C. 6a(a)(3)(A).

[762] See discussion above.

the prevention of market manipulation provided by spot-month position limits by reducing the potential for adverse incentives to manifest in manipulative action.

b. <u>§ 150.2(b) single-month and all-months-combined speculative position limits</u>

CEA section 4a(a)(3)(A) further directs the Commission to set limits on speculative positions for months other than the spot-month.[763] While market disruptions arising from the concentration of positions remain a possibility outside the spot month, the above-mentioned concerns about corners and squeezes and other forms of manipulation are reduced because the potential for the same is reduced outside the spot-month. Accordingly, the Commission has proposed to use its discretion to require netting of physical-delivery and cash-settled referenced contracts for purposes of determining compliance with non-spot-month limits. The Commission deems it is appropriate to provide traders with additional flexibility in complying with the non-spot-months limits given their decreased risk of corners and squeezes. Because this additional flexibility means market participants are able to retain offsetting positions outside of the spot-month, liquidity should not be impaired and price discovery should not be disrupted.

c. <u>§ 150.2(e) levels of speculative position limits</u>

The proposed methodology for determining the levels at which the limits are set is consistent with the Commission's longstanding acceptable practices for DCM-set speculative position limits. Further, the Commission's proposal to set initial spot-month limits at the current federal or DCM-set levels for each core referenced futures contract

[763] 7 U.S.C. 6a(a)(3)(A).

means that any trading activity that is compliant with the current position limits regime generally will continue to be compliant under the first two years of the proposed rule.[764]

The proposed rule is designed to result in speculative position limit levels that prevent excessive speculation and deter market manipulation without diminishing market liquidity. Specifically, levels that are too low may be binding and overly restrictive, but levels that are too high may not adequately protect against manipulation and excessive speculation. The Commission believes that both standards — i.e., spot month limits of not greater than 25 percent of deliverable supply and the 10 and 2.5 percent formula for non-spot-month limits — produce levels for speculative position limits that help to ensure that both policy objectives — to deter market manipulation and excessively large speculative positions and to maintain adequate market liquidity — are achieved to the maximum extent practicable.

The Commission's review of the number of potentially affected traders indicates that the proposed rule will not significantly affect market liquidity. Over the last two full years (2011-2012), an average of fewer than 40 traders in any one of the 28 proposed markets exceeded just 60 percent of the level of the proposed spot-month position limit. An average of fewer than 10 of those traders exceeded 100 percent of the proposed level of the spot-month limit.[765] In several months over the period, no trader exceeded the proposed level of the spot-month limits and some months saw a much larger number of traders with positions in excess of the proposed level of the spot-month limits. Smaller

[764] The Commission notes that the CME Group submitted an estimate of deliverable supply that, if used by the Commission as a base for setting initial levels of spot month limits, would result in higher spot month limits than those currently proposed in appendix D. See discussion above for more information.

[765] To put this figure in context, over the same period the number of unique owners over at least one of the proposed limit levels in the 28 proposed markets was 384, while 932 unique owners were over 60 percent of at least one of the proposed limit levels. In contrast, under the large trader reporting provisions of part 17, there are thousands of traders with reportable positions as defined in § 15.00(p).

numbers were revealed when observing traders' positions in relation to proposed levels for non-spot-month position limits — an average of fewer than 10 traders exceeded 60 percent of the proposed all-months-combined limit. The analysis reviewed by the Commission does not account for hedging and other exemptions, which leads the Commission to believe that the number of speculative traders in excess of the proposed limit is even smaller. The relatively low number of traders that may exceed proposed limits in non-spot-months is indicative of the flexibility of the limit formula to account for changes in market participation.

d. Request for Comment

The Commission welcomes comment on its considerations of the benefits of proposed § 150.2. What other benefits of the provisions in § 150.2 should the Commission consider? Has the Commission accurately identified the potential benefits of the proposed rules?

iii. Costs

The expansion of § 150.2 will necessarily create some additional compliance costs for market participants. The Commission has attempted, where feasible, to reduce such burdens without compromising its policy objectives.

a. § 150.2(a)-(b) spot-month, single-months, and all-months-combined speculative position limits; other considerations

Notwithstanding the above analysis of potentially affected traders, the Commission anticipates that some market participants still may find it necessary to reassess and modify existing trading strategies in order to comply with spot- and non-spot-month position limits for the 28 commodities with applicable federal limits, though

the Commission believes much of these costs to be the direct result of the statutory mandate to impose limits. The Commission anticipates any such costs would be largely incurred by swaps-only entities, as futures and options market participants have experience with position limits, particularly in the spot-month, such that the costs of any strategic or trading changes that needed to be made may have already been incurred. These costs are not reasonably quantifiable by the Commission, due to their highly variable and entity-specific nature, and because trading strategies are proprietary, but to the extent an expanded position limits regime alters the ways a trader conducts speculative trading activity, such costs may be incurred.

Broadly speaking, imposing position limits raises the concerns that liquidity and price discovery may be diminished, because certain market segments, i.e., speculative traders, are restricted. The Commission has endeavored to mitigate concerns about liquidity and price discovery, as well as costs to market participants, by expanding limits to additional markets incrementally in order to facilitate the transition to the expanded position limits regime. For example, the Commission has proposed to adopt current spot-month limit levels as the initial levels in order to ensure traders know well in advance of the effective date of the rule what limits will be on that date. The Commission also expects a large number of swaps traders to avail themselves of the pre-existing position exemption as defined in proposed § 150.3. As preexisting positions are replaced with new positions, traders will be able to incorporate an understanding of the new regime into existing and new trading strategies, which allows the burden of altering strategies to happen incrementally over time. The preexisting position exemption applies to non-spot-

month positions entered into in good faith prior to (i) the enactment of the Dodd-Frank Act or (ii) the effective date of this proposed rule.

Implementing the statutory requirement of CEA section 4a(a)(6), the aggregate limits proposed in § 150.2 would impact, as described above, market participants who are active across trading venues in economically equivalent contracts. Under current practice, speculative traders may hold positions up to the limit in each derivative product for which a limit exists. In contrast, aggregate limits cap all of a speculative market participant's positions in derivatives contracts for a particular commodity. In some circumstances, the aggregate limit will prevent traders from entering into positions that would have otherwise been permitted without aggregate limits.[766] The proposed rule incorporates features that provide counterbalancing opportunities for speculative trading.

First, the limits apply separately to physical-delivery and cash-settled contracts in the spot-month. Physical-delivery core referenced futures contracts have one limit; cash-settled reference contracts traded on the same exchange, a different exchange, or over-the-counter have a separate, but equal, limit. Therefore, a speculative trader may hold positions up to the spot month limit in both the physical-delivery core referenced futures contract, and a cash-settled contract (i.e., cash-settled future and/or swap).

The second feature is the proposed conditional spot-month limit exemption. As discussed in a subsequent section of this release, the conditional spot-month limit exemption allows a speculative trader to hold a position in a cash-settled contract that is up to five times the spot-month limit of the core referenced futures contract, provided that

[766] For example, a market participant has a position close to the spot-month limit in the NYMEX cash-settled crude oil contract is currently able to take the same size position in the ICE cash-settled crude oil contract. The proposed rule would, in accordance with the statutory requirement of CEA section 4a(a)(6), require that the positions on NYMEX and ICE be aggregated for the purposes of complying with the limit — effectively halving the limit.

trader does not hold any position in the physical-delivery core referenced futures contract.

Finally, federal non-spot-month limits are calculated as a fixed ratio of total open interest in a particular commodity across all markets for referenced contracts. Because of this feature of the Commission's formula for calculating non-spot-month limit levels and of the proposed rule's application of non-spot-month limits on an aggregate basis across all markets, the imposition of the required aggregate limits should not unduly impact positions outside of the spot-month, as evidenced by the relatively few number of traders that would have been impacted historically, noted in table 11, supra.

b. § 150.2(e) levels of speculative position limits

Market participants would incur costs to monitor positions to prevent a violation of the limit level. The Commission expects that large traders in the futures and options markets for the 28 core referenced futures contracts have already developed some system to control the size of their positions on an intraday basis, in compliance with the longstanding position limits regimes utilized by both the Commission on a federal level and DCMs on an exchange level and in light of industry practices to measure, monitor, and control the risk of positions. For these traders, the Commission anticipates a small incremental burden to accommodate any physical commodity swap positions that such traders may hold that would become subject to the position limits regime. The Commission, subject to evidence establishing the contrary, believes the burden will be minimal because futures and options market participants are currently monitoring trading to track, among other things, their positions vis-à-vis current limit levels. For those participating in the futures and options markets, the Commission estimates two to three

labor weeks to adjust monitoring systems to track position limits for referenced contracts, including swaps and other economically equivalent contracts traded on other trading venues. Assuming an hourly wage of $120,[767] multiplied by 120 hours, this implementation cost would amount to approximately $14,000 per entity.

The incremental costs of compliance with the proposed rule would be higher for speculative traders who have until now traded only or primarily in swap contracts.[768] Specifically, swaps-only traders may potentially incur larger start-up costs to develop a compliance system to monitor their positions in referenced contracts and to comply with an applicable position limit. Though swaps-only market participants have not historically been subject to position limits, swap dealers and major swap participants (as defined by the Commission pursuant to the Dodd-Frank Act) are required in § 23.601 to implement systems to monitor position limits.[769] In addition, many of these entities have already developed systems or business processes to monitor or control the size of swap positions for a variety of business reasons, including (i) managing counterparty credit risk exposure; and (ii) limiting and monitoring the risk exposure to such swap positions. Such

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[767] The Commission's estimates concerning the wage rates are based on 2011 salary information for the securities industry compiled by the Securities Industry and Financial Markets Association ("SIFMA"). The Commission is using $120 per hour, which is derived from a weighted average of salaries across different professions from the SIFMA Report on Management & Professional Earnings in the Securities Industry 2011, modified to account for an 1800-hour work-year, adjusted to account for the average rate of inflation in 2012, and multiplied by 1.33 to account for benefits and 1.5 to account for overhead and administrative expenses. The Commission anticipates that compliance with the provisions would require the work of an information technology professional; a compliance manager; an accounting professional; and an associate general counsel. Thus, the wage rate is a weighted national average of salary for professionals with the following titles (and their relative weight); "programmer (senior)" and "programmer (non-senior)" (15% weight), "senior accountant" (15%) "compliance manager" (30%), and "assistant/associate general counsel" (40%). All monetary estimates have been rounded to the nearest hundred dollars.

[768] The Commission notes that costs associated with the inclusion of swaps contracts in the federal position limits regime are the direct result of changes made by the Dodd-Frank Act to section 4a of the Act. The Commission presents a discussion of these costs in order to be transparent regarding the effects of the proposed rules.

[769] See 17 CFR 23.601.

existing systems would likely make compliance with position limits significantly less burdensome, as they may be able to leverage current monitoring procedures to comply with this rule. The Commission anticipates that a firm could select from a wide range of compliance systems to implement a monitoring regime. This flexibility allows the firm to tailor the system to suit its specific needs in a cost-effective manner.

In the release adopting now-vacated part 151, the Commission recognized the potentially firm-specific and highly variable nature of implementing monitoring systems. In particular, the Commission presented estimates of, on average, labor costs per entity ranging from 40 to 1,000 hours, $5,000 to $100,000 in five-year annualized capital/start-up costs, and $1,000 to $20,000 in annual operating and maintenance costs.[770] The Commission explained that costs would likely be lower for firms with positions far below the speculative limits, but higher for firms with large or complex positions as those firms may need comprehensive, real-time analysis.[771] The Commission further explained that due to the variation in both number of positions held and degree of sophistication in existing risk management systems, it was not feasible for the Commission to provide a greater degree of specificity as to the particularized costs for swaps firms.[772]

At this time, the Commission remains in the early stages of implementing the suite of Dodd-Frank Act regulations addressing swap markets now under its jurisdiction. The Commission is registering swap dealers and major swaps participants for the first

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[770] See 76 FR at 71667. The presentation of costs on a five-year annualized basis is consistent with requirements under the Paperwork Reduction Act ("PRA"). See OMB Form 83-I requiring the Commission's Paperwork Reduction Act analysis be submitted with "annualized" costs in all categories. Instructions for the form do not provide instructions for annualizing costs; the Commission chose to annualize over a five year period.

[771] Id. (n. 401).

[772] Id.

time. Much of the infrastructure, including execution facilities, of the new markets has only recently become operational, and the collection of comprehensive regulatory data on physical commodity swaps is in its infancy. Because of this, the Commission is unable to estimate with precision the likely number of impacted swaps-only traders who would be subject to position limits for the first time. However, the Commission preliminarily believes that a relatively small number of swaps-only traders will be affected. The Commission anticipates that most of the traders in swaps markets that accumulate physical commodity swap positions of a sufficiently high volume to engender concern for crossing position limit thresholds either: are required to register as swap dealers or major swaps participants and as such already have systems in place to monitor limits in accordance with § 23.601; or, are also active in futures markets and as such have the ability to leverage existing strategies for monitoring limits.

Accordingly, for purposes of proposing these amendments to § 150.2, the Commission again estimates that swaps entities will incur, on average, labor costs per entity ranging from 40 to 1,000 hours; between $25,000 and $500,000 in total (non-annualized) capital/start-up costs and $1,000 to $20,000 in annual operating and maintenance costs. These estimates provide a preliminary range of costs for monitoring positions that reflects, on average, costs that market participants may incur based on their specific, individualized needs.

Finally, proposed § 150.2(e)(3)(ii) requires DCMs that list a core referenced futures contract to supply to the Commission estimates of deliverable supply. The Commission proposes to require staggered submission of the deliverable supply estimates in order to spread out the administrative burden of the proposed rules. Further, for

contracts with DCM-set limits, an exchange would have already estimated deliverable supply in order to set spot-month position limit or demonstrate continued compliance with core principles 3 and 5. Thus, the Commission does not anticipate a large burden to result from the proposed § 150.2(e)(3)(ii). The Commission preliminarily believes that, as estimated in accordance with the Paperwork Reduction Act ("PRA"), the submission would require a labor burden of approximately 20 hours per estimate. Thus, a DCM that submits one estimate may incur a burden of 20 hours for a cost, using the estimated hourly wage of $120,[773] of approximately $2,400. DCMs that submit more than one estimate may multiply this per-estimate burden by the number of estimates submitted to obtain an approximate total burden for all submissions, subject to any efficiencies and economies of scale that may result from submitting multiple estimates.

c. <u>Request for comment</u>

Do the estimates presented accurately reflect the expected costs of monitoring position limits under the proposed rule? Would the proposed rule engender material costs for monitoring positions addition to those the Commission has identified? Are the assumptions reflected in the Commission's consideration of the proposed rule's costs to monitor limits valid? If not, why and to what degree?

Is the Commission's view that aggregate limits as proposed will not create overly restrictive limit levels valid? Would the aggregated, cross-exchange nature of the limits as proposed in § 150.2 engender material costs that the Commission has not identified?

Are there other cost factors related to operational changes that the Commission should consider? What other factors should the Commission consider?

The Commission requests that commenters submit data or other information to assist it in quantifying anticipated costs of proposed § 150.2 and to support their own assertions concerning costs associated with proposed § 150.2.

iv. Consideration of alternatives

The Commission recognizes there exist alternatives to its discretionary proposals herein. These include the alternative of setting initial levels for spot month speculative position limit based on estimates of deliverable supply, as provided by the CME Group, rather than at the levels proposed in appendix D. The Commission requests comment on whether an alternative to what is proposed, including setting initial limits based on a current estimate of deliverable supply, would result in a superior benefit-cost profile, with support for any such position provided.

4. Section 150.3 – Exemptions

CEA section 4a(a)(7), added by the Dodd-Frank Act, authorizes the Commission to exempt, conditionally or unconditionally, any person, swap, futures contract, or option — as well as any class of the same — from the position limit requirements that the Commission establishes. Current § 150.3 specifies three types of positions for exemption from calculation against the federal limits prescribed by the Commission under §150.2: (1) bona fide hedges, (2) spreads or arbitrage between single months of a futures contract (and/or, on a futures-equivalent basis, options), and (3) those of an "eligible entity" as that term is defined in §150.1(d)[774] carried in a separate account by an independent

[774] For example, an operator of a commodity pool or certain other trading vehicle, a commodity trading advisor, or another specified financial entity such as a bank, trust company, savings association, or insurance company.

account controller ("IAC")[775] when specific conditions are met. The Commission proposes to make organizational and conforming changes to § 150.3 as well as several substantive changes. By exempting positions that pose less risk of unduly burdening interstate commerce from position limit regulation, these substantive revisions would further the Commission's mission specified in CEA section 4a(a)(3).

The proposed organizational/conforming changes consist of updating cross references;[776] relocating the IAC exemption to consolidate it with the Commission's separate proposal to amend the aggregation requirements of § 150.4;[777] and deleting the calendar month spread provision that, due to changes proposed under § 150.2, would be rendered unnecessary.[778] These amendments will facilitate reader ease-of-use and clarity. However, the Commission foresees little additional impact from these non-substantive proposed amendments.

The proposed substantive changes to § 150.3 would revise an existing exemption, add three additional exemptions, and revise recordkeeping requirements. As summarized in the section below, proposed § 150.3 would: (i) codify in Commission regulation the statutory requirement of CEA section 4a(c)(1) that federal position limits not apply to bona fide hedging as defined by the Commission; (ii) add exemptions for financial

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[775] IACs are defined currently in 17 CFR 150.1(e). Amendments to that definition are being proposed in a separate release. See Aggregation NPRM.

[776] Specifically, as described above: a) proposed § 150.3(a)(1)(i) would update the cross-references to the bona fide hedging definition to reflect its proposed replacement in amended § 150.1 from its current location in § 1.3(z); b) proposed § 150.3(a)(3) would add a new cross-reference to the reporting requirements proposed to be amended in part 19; and c) proposed § 150.3(i) would add a cross-reference to the updated aggregation rules in proposed § 150.4.

[777] See Aggregation NPRM. The exemption for accounts carried by an IAC is set out in proposed § 150.4(b)(5); adoption of that proposal would render current § 150.3(a)(4) duplicative.

[778] More specifically, as discussed supra, the Commission proposes to amend § 150.2 to increase the level of single month position limits to the same level as all months limits. As a result, the spread exemption set forth in current § 150.3(a)(3) that permits a spread trader to exceed single month limits only to the extent of the all months limit would no longer provide useful relief.

distress situations, certain spot-month positions in cash-settled reference contracts, and pre-Dodd-Frank and transition period swaps; (iii) provide guidance for non-enumerated exemptions, including the deletion of § 1.47; and (iv) revise recordkeeping requirements for traders claiming any exemption from the federal speculative position limits.

i. Rule summary

a. Section 150.3(a) bona fide hedging exemption

As does current §150.3(a)(1), proposed § 150.3(a)(1)(i) will codify the statutory requirement that bona fide hedging positions be exempt from federal position limits. To the extent that benefits and costs would derive from the Commission's proposed amendment in § 150.1 to the definition of "bona fide hedging position" that is discussed above. This proposed amendment would also require that the anticipatory hedging requirements proposed in § 150.7, the recordkeeping requirements proposed in § 150.3(g), and the reporting requirements in proposed part 19 are met in order to claim the exemption. Any benefits and costs attributable to these features of the rule are considered below in the respective discussions of proposed § 150.7, § 150.3(g) and Part 19.

b. Section 150.3(b) financial distress exemption

Proposed § 150.3(b) provides the means for market participants to request relief from applicable speculative position limits during times of market stress. The proposed rule allows for exemption under certain financial distress circumstances, including the default of a customer, affiliate, or acquisition target of the requesting entity, that may require an entity to assume in short order the positions of another entity.

c. Section 150.3(c) conditional spot-month limit exemption

Proposed § 150.3(c) would provide a conditional spot-month limit exemption that permits traders to acquire positions up to five times the spot month limit if such positions are exclusively in cash-settled contracts. The conditional exemption would not be available to traders who hold or control positions in the spot-month physical-delivery referenced contract in order to reduce the risk that traders with large positions in cash-settled contracts would attempt to distort the physical-delivery price to benefit such positions.

The proposed conditional exemption is consistent with current exchange-set position limits on certain cash-settled natural gas futures and swaps.[779] Both NYMEX and ICE have established conditional spot month limits in their cash-settled natural gas contracts at a level five times the level of the spot month limit in the physical-delivery futures contract. Since spot-month limit levels for referenced contracts will be set at no greater than 25 percent of the estimated deliverable supply in the relevant core referenced futures contract, the proposed exemption would allow a speculative trader to hold or control positions in cash-settled referenced contracts equal to no greater than 125 percent of the spot month limit.

Historically, the Commission has been particularly concerned about protecting the spot month in physical-delivery futures contracts because they are most at risk for corners and squeezes. This acute risk is the reason that speculative limits in physical-delivery markets are generally set more restrictively during the spot month. The conditional exemption, as proposed, would constrain the potential for manipulative or disruptive activity in the physical-delivery contracts during the spot month by capping speculative trading in such contracts; however, in parallel cash-settled contracts, where the potential

[779] See discussion above.

for manipulative or disruptive activity is much lower, the conditional exemption would broaden speculative trading opportunity, potentially providing additional liquidity for bona fide hedgers in cash-settled contracts.

In proposing the conditional limit, the Commission has examined market data on the effectiveness of conditional spot-month limits in natural gas markets, including the data submitted as part of the rulemaking for now-vacated part 151.[780] The Commission has also examined market data in other contracts, and has observed that open interest levels naturally decline in the physical-delivery contract leading up to and during the spot month, as the contract approaches expiration.[781] Both hedgers and speculators exit the physical-delivery contract in order to, for example, roll their positions to the next contract month or avoid delivery obligations. Market participants in cash-settled contracts, however, tend to hold their positions through to expiration. This market behavior suggests that the conditional spot-month limit exemption should not affect liquidity in the spot month of the physical-delivery contract, as open interest is rapidly declining.[782] The exemption, would, however, provide the opportunity for speculative trading to increase in the cash-settled contract. The Commission preliminarily believes that while this proposed exemption would remove certain constraints from speculative trading in cash-settled contracts, it would not damage liquidity in the aggregate, i.e., across physical-delivery and cash-settled contracts in the same commodity. On this basis, the Commission preliminarily believes a conditional limit in additional commodities is

[780] See 76 FR at 71635 (n. 100–01).

[781] See discussion above.

[782] Traders participating in the physical-delivery contract in the spot month are understood to have a commercial reason or need to stay in the spot month; the Commission preliminarily believes at this time that it is unlikely that the factors keeping traders in the spot month physical-delivery contract will change due solely to the introduction of a higher cash-settled contract limit.

consistent with the statutory direction to deter manipulation while ensuring sufficient liquidity for bona fide hedgers without disrupting the price discovery process.

The Commission's current proposal would not restrict a trader's cash commodity position. Instead, the Commission proposes to require enhanced reporting of cash market positions of traders availing themselves of the conditional spot-month limit. As discussed in the proposed changes to part 19, the Commission proposes to initially require this enhanced reporting only for the natural gas contract until it gains more experience administering the conditional spot month limit in the other referenced contracts. The Commission preliminarily believes that the proposed reporting regime in natural gas will provide useful information that can be deployed by surveillance staff to detect and potentially deter manipulative schemes involving the cash market.

d. Section 150.3(d) pre-enactment and transition period swaps exemption

To implement the statutory requirement of CEA section 4a(b)(2),[783] proposed § 150.3(d) would provide an exemption from federal position limits for swaps entered into prior to July 21, 2010 (the date of the enactment of the Dodd-Frank Act), the terms of which have not expired as of that date, and for swaps entered into during the period commencing July 22, 2010, the terms of which have not expired as of that date, and ending 60 days after the publication of final rule § 150.3 in the Federal Register, i.e., its effective date. The Commission would allow both pre-enactment and transition swaps to be netted with commodity derivative contracts acquired more than 60 days after publication of final rule § 150.3 in the Federal Register for the purpose of complying with

[783] CEA section 4a(b)(2) states in part that "any position limit fixed by the Commission … shall not apply to a position acquired in good faith prior to the effective date of such rule, regulation or order." 7 U.S.C. 6a(b)(2).

any non-spot-month position limit.[784] This exemption facilitates the transition to full position limits compliance for previously unregulated swaps markets. Allowing netting with pre-enactment and transition swaps provides flexibility where possible in order to lessen the impact of the regime on entities that trade swaps.

e. Section 150.3(e) and (f) other exemptions and previously granted exemptions

Proposed § 150.3(e) and (f) provide information on other exemptive relief not specified by other sections of § 150.3. The Commission previously permitted a person to file an application seeking approval for a non-enumerated position to be recognized as a bona fide hedging position under § 1.47. Though the Commission is proposing to delete § 1.47, the Commission believes it is appropriate to provide persons the opportunity to seek exemptive relief.

Proposed § 150.3(e) provides guidance to persons seeking exemptive relief. A person engaged in risk-reducing practices that are not enumerated in the revised definition of bona fide hedging in proposed § 150.1 may use two different avenues to apply to the Commission for relief from federal position limits. The person may request an interpretative letter from Commission staff pursuant to § 140.99[785] concerning the applicability of the bona fide hedging position exemption, or may seek exemptive relief from the Commission under section 4a(a)(7) of the Act.[786]

f. Section 150.3(g) and (h) recordkeeping

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[784] Because of concerns regarding manipulation during the delivery period of a referenced contract, the proposed rule would not allow pre- and post- enactment and transition swaps to be netted for the purpose of complying with any spot-month position limit.

[785] 17 CFR 140.99 defines three types of staff letters – exemptive letters, no-action letters, and interpretative letters – that differ in terms of scope and effect. An interpretative letter is written advice or guidance by the staff of a division of the Commission or its Office of the General Counsel. It binds only the staff of the division that issued it (or the Office of the General Counsel, as the case may be), and third-parties may rely upon it as the interpretation of that staff.

[786] See supra discussion of CEA section 4a(a)(7).

Proposed § 150.3(g)(1) specifies recordkeeping requirements for persons who claim any exemption set forth in proposed § 150.3. Persons claiming exemptions under § 150.3 would need to maintain complete books and records concerning all details of their related cash, forward, futures, options and swap positions and transactions. Proposed § 150.3(g)(1) is largely duplicative of other recordkeeping obligations imposed on market participants, including provisions in § 1.35 and § 18.05 as amended by the Commission to conform with the Dodd-Frank Act.[787] Proposed § 150.3(g)(2) require persons seeking to rely upon the pass-through swap offset exemption to obtain a representation from its counterparty that the swap qualifies as a bona fide hedging position and to retain this representation on file. Similarly, proposed § 150.3(g)(3) requires a person who makes such a representation to maintain records supporting the representation. Under proposed § 150.3(h), all persons would need to make such books and records available to the Commission upon request, which would preserve the "call for information" rule set forth in current §150.3(b).

ii. <u>Benefits</u>

In articulating exemptions from position limit requirements, §150.3 works in concert with § 150.2 as it pertains to Commission-specified federal limits and with certain requirements of §150.5 pertaining to exchange-set position limits. Functioning as an integrated component within the broader position-limits regulatory regime, the Commission believes the proposed changes to § 150.3 accomplish, to the maximum extent practicable, the four objectives outlined in CEA section 4a(a)(3). As such, the

[787] 77 FR 66288, Nov. 2, 2012.

Commission perceives these proposed amendments to offer significant benefits. These are explained more specifically below.

a. Section 150.3(b) financial distress exemption

In codifying the Commission's historical practice of temporarily lifting position limit restrictions, the proposed rule further strengthens the benefits of accommodating transfers of positions from financially distressed firms to financially secure firms or facilitating other necessary remediation measures during times of market stress. More specifically, due to the improved facility and transparency with respect to the availability of this exemption, it becomes less likely that positions will be prematurely or unnecessarily liquidated. The disorderly liquidation of a position poses the threat of price impacts that may harm the efficiency as well as the price discovery function of markets. In addition, the availability of a financial distress exemption provides market participants with a degree of confidence that the Commission has the appropriate tools to facilitate the transfer of positions expeditiously in times of market uncertainty.

b. Section 150.3(c) conditional spot-month limit exemption

The conditional spot-month limit exemption provides speculators with an opportunity to maintain relatively large positions in cash-settled contracts up to but no greater than 125 percent of the spot-month limit. By prohibiting speculators using the exemption in the cash-settled contract from trading in the spot-month of the physical-delivery contract, the proposed rules should further protect the delivery and settlement process. In addition, the condition of the exemption — i.e., a trader availing himself of the exemption may not have any position in the physical-delivery contract —reduces the ability for a trader with a large cash-settled contract position to attempt to manipulate the

physical-delivery contract price in order to benefit his position. As such, the conditional spot-month limit exemption would further three of the goals under CEA section 4a(a)(3) — deterring market manipulation, and ensuring sufficient market liquidity for bona fide hedgers, without disrupting the price discovery process.

The proposed rules are specifically intended to provide an alternate structure to the one that is currently in place that also meets the objectives to deter and prevent manipulation and to ensure sufficient market liquidity. In this way, the conditional limit exemption provides flexibility for market participants and the Commission to meet the objectives outlined in CEA section 4a(a)(3). The Commission expects that market participants will respond to the flexibility afforded by the proposed exemption in order to fulfill their needs in a manner that is consistent with their business interests, although it cannot reasonably predict how markets, DCMs and market participants will adapt. Accordingly, the Commission requests comment on this exemption, its potential impacts on trading strategies, competition, and any other direct or indirect costs to markets or market participants and exchanges that could arise as a result of the conditional spot-month limit exemption.

c. <u>Section 150.3(d) pre-enactment and transition period swaps exemption</u>

The pre-existing swaps exemption in proposed § 150.3(d) is consistent with CEA section 4a(b)(2). This exemption facilitates the transition to full position limits compliance for previously unregulated swaps markets. Allowing netting with post-enactment swaps outside of the spot-month provides flexibility where possible in order to lessen the impact of the regime on entities that trade swaps.

d. <u>Section 150.3(e)-(f) other exemptions and previously granted exemptions</u>

The proposed amendments to § 150.3(e) and the replacement of existing § 1.47 with new proposed § 150.3(f) are essentially clarifying and organizational in nature. As such they will confer limited substantive benefits beyond providing market participants with clarity regarding the process for obtaining non-enumerated exemptive relief and promoting regulatory certainty for those granted exemptions pursuant to § 1.47.

e. Section 150.3(g) recordkeeping

By requiring that market participants who avail themselves of the exemptions offered under §150.3 maintain certain records to document their exemption eligibility and make such records available to the Commission on request, the rule reinforces proposed §150.2 and §150.3 and helps to accomplish, to the maximum extent practicable, the goals set out in CEA section 4a(a)(3)(B). Supporting books and records are critical to the Commission's ability to effectively monitor compliance with exemption eligibility standards each and every time an exemption is employed. Absent this ability, exemptions are more susceptible to abuse. This susceptibility increases the potential that position limits function in a diminished capacity than intended to prevent excessive speculation and/or market manipulation.

f. Request for comment

The Commission requests comments on its considerations of the benefits associated with the proposed amendments to § 150.3, including data or other information to assist the Commission in identifying the number and type of market participants that will realize, respectively, the benefits identified and/or to monetize such benefits. Has the Commission correctly identified market behavior and incentives that affect or would likely be affected by the conditional spot-month limit exemption? What other potential

benefits could the conditional spot-month limit exemption have for markets and/or market participants? Will the exemptions proposed likely result in any benefits, direct or indirect, for markets and/or market participants in addition to those that the Commission has identified? If so, what, and why and how will they result? Has the Commission misidentified or overestimated any benefits likely to result from the proposed exemptions? If so, which and/or to what extent?

iii. Costs

In general, the exemptions proposed in § 150.3 do not increase the costs of complying with position limits, and in fact may decrease these costs by providing for relief from speculative limits in certain situations. The exemptions are elective, so no entity is required to assert an exemption if it determines the costs of doing so do not justify the potential benefit resulting from the exemption. Thus, the Commission does not anticipate the costs of obtaining any of the exemptions to be overly burdensome. Nor does the Commission anticipate the costs would be so great as to discourage entities from utilizing available exemptions, as applicable.

Potential costs attendant to the proposed amendments to § 150.3 are discussed specifically below.

a. Section 150.3(b) financial distress exemption

The Commission anticipates the costs associated with the codification of the financial distress exemption to be minimal. Market participants who voluntarily employ these exemptions will incur costs stemming from the requisite filing and recordkeeping obligations that attend the exemptions.[788] Along with performing its due diligence to

[788] See supra considerations of costs and benefits of the proposed amendments to part 19 and the Paperwork Reduction Act.

acquire a distressed firm, or positions held or controlled by a distressed firm, an entity would have to update and submit to the Commission a request for the financial distress exemption. The Commission is unable at this time to accurately estimate how often this exemption may be invoked, as emergency or distressed market situations by nature are unpredictable and dependent on a variety of firm- and market-specific idiosyncratic factors as well as general macroeconomic indicators. Given the unusual and unpredictable nature of emergency or distressed market situations, the Commission anticipates that this exemption would be invoked infrequently, but is unable to provide a more precise estimate. The Commission also assumes that codifying the proposed rule and thus lending a level of transparency to the process will result in an administrative burden that is less onerous than the current regime. In addition, the Commission believes that in the case that one firm is assuming the positions of a financially distressed firm, the costs of claiming the exemption would be incidental to the costs of assuming the position.

b. <u>Section 150.3(c) conditional spot-month limit exemption</u>

A market participant that elects to exercise this exemption, one that is not available under current rules, will incur certain direct costs to do so. A person seeking to utilize this exemption for the natural gas market must file Form 504 in accordance with requirements listed in proposed § 19.01.[789] If that person currently has any position in the physical-delivery contract, such person may incur costs associated with liquidating that position in order to meet the conditions of the conditional spot-month limit exemption. As previously discussed, the conditional spot month limit is designed to deter market manipulation without disrupting the price discovery process. The Commission

[789] Specific costs associated with filing Form 504 are considered above in the sections that implement that form, namely the discussion of the costs and benefits of proposed amendments to part 19 and the Paperwork Reduction Act .

does not have reason to believe that liquidity, in the aggregate (across the core referenced and referenced contracts), will be adversely impacted. However, the proposed rules are specifically intended to provide an alternative to the position limit regime that is currently in place for the purpose of deterring and preventing manipulation and ensuring sufficient market liquidity; the Commission expects that market participants will respond to the flexibility afforded by the proposed exemption in order to fulfill their needs in a manner that is consistent with their business interests, although it cannot reasonably predict how markets, DCMs and market participants will adapt. Accordingly, the Commission requests comment on this exemption, its potential impacts on trading strategies, competition, and any other direct or indirect costs to markets or market participants and exchanges that could arise as a result of the conditional spot-month limit exemption.

c. Section 150.3(d) pre-enactment and transition period swaps exemption

The exemption offered in proposed § 150.3(d) is self-executing and would not require a market participant to file for relief. However, a firm may incur costs to identify positions eligible for the exemption and to determine if that position is to be netted with post-enactment swaps for purposes of complying with a non-spot-month position limit. Such costs would be assumed voluntarily by a market participant in order to avail itself of the exemption, and the Commission does not anticipate these costs to be overly burdensome.

d. Section 150.3(e)-(f) other exemptions and previously granted exemptions

Under the proposed § 150.3(e), market participants electing to seek an exemption other than those specifically enumerated, will incur certain direct costs to do so. First, they will incur costs related to petitioning the Commission under § 140.99 of the

Commission's regulations or under CEA section 4a(a)(7). To the extent these costs may be marginally greater than a market participant would experience to seek an exemption under the process afforded under current §1.47 — something the Commission cannot rule out at this time — the cost difference between the two is attributable to this rulemaking.[790] Further, market participants who had previously relied upon the exemptions granted under § 1.47 would be able to continue to rely on such exemptions for existing positions. Going forward, market participants would need to enter into a new position that fits within applicable limits or are eligible for an alternate exemption, in which case the participants may incur costs associated with applying for such exemptions. The Commission is unable to ascertain at this time the number of participants affected by these proposed regulations. The Commission notes, however, that a decision to incur the costs inherent in seeking relief is voluntary.

e. <u>Section 150.3(g) recordkeeping</u>

Finally, any person that elects to exercise an exemption provided in proposed § 150.3 would incur costs attributable to additional recordkeeping obligations under proposed § 150.3(e)-(g). The Commission preliminarily believes that these costs will be minimal, as participants already maintain books and records under a variety of other Commission regulations and as the information required in these sections is likely already being maintained as part of prudent accounting and risk management policies and procedures. The Commission preliminarily believes that, as estimated in accordance with the PRA, a total of 400 entities will incur an annual labor burden of approximately 50

[790] Alternatively, to the extent petitioning the Commission under § 140.99 or under CEA section 4a(a)(7) results in lower costs relative to those necessary to utilize the current § 1.47 process, the cost difference is a benefit attributable to this rulemaking. The Commission requests comment concerning whether, and to what degree, requiring petitions for exemption under § 140.99 or under CEA section 4a(a)(7) in place of current § 1.47 is likely to result in any material cost difference.

hours each, or 20,000 total hours for all affected entities, to comply with the additional recordkeeping obligations. Using an estimated hourly wage of $120 per hour,[791] the Commission anticipates an annual burden of approximately $6,000 per entity and a total of $2,400,000 for all affected entities.

f. Request for comment

The Commission requests comment on its considerations of the costs associated with the proposed changes to § 150.3. Are there other costs associated with new exemptions that the Commission should consider? With respect to the proposed conditional spot-month limit exemption, specifically, the Commission welcomes comments regarding the potential cost impact on trading strategies, any other direct or indirect costs to markets or market participants that could arise as a result of it, and the estimated number of impacted entities.

iv. Consideration of alternatives

The Commission recognizes that alternatives may exist to discretionary elements of § 150.3 proposed herein. The Commission requests comment on whether an alternative to what is proposed would result in a superior benefit-cost profile, with support for any such position provided.

5. Section 150.5 – Exchange-set speculative position limits

[791] The Commission's estimates concerning the wage rates are based on 2011 salary information for the securities industry compiled by the Securities Industry and Financial Markets Association ("SIFMA"). The Commission is using $120 per hour, which is derived from a weighted average of salaries across different professions from the SIFMA Report on Management & Professional Earnings in the Securities Industry 2011, modified to account for an 1800-hour work-year, adjusted to account for the average rate of inflation in 2012, and multiplied by 1.33 to account for benefits and 1.5 to account for overhead and administrative expenses. The Commission anticipates that compliance with the provisions would require the work of an information technology professional; a compliance manager; an accounting professional; and an associate general counsel. Thus, the wage rate is a weighted national average of salary for professionals with the following titles (and their relative weight); "programmer (senior)" and "programmer (non-senior)" (15% weight), "senior accountant" (15%) "compliance manager" (30%), and "assistant/associate general counsel" (40%). All monetary estimates have been rounded to the nearest hundred dollars.

Current § 150.5 addresses the requirements and acceptable practices for exchanges in setting speculative position limits or position accountability levels for futures and options contracts traded on each exchange. As further described above,[792] the CFMA's amendments to the CEA in 2000 gave DCMs discretion to set those limits or levels within the statutory requirements of core principle 5.[793] With this grant of statutory discretion, § 150.5 became non-binding guidance and accepted practice to assist the exchanges in meeting their statutory responsibilities under the core principles.[794] Subsequently, the Dodd-Frank Act scaled back the discretion afforded DCMs for establishing position limits under the earlier CFMA amendments. Specifically, among other things, the 2010 law: (1) amended core principle 1 to expressly subordinate DCMs' discretion in complying with statutory core principles to Commission rules and regulations; and (2) amended core principle 5 to additionally require that, with respect to contracts subject to a position limit set by the Commission under CEA section 4a, a DCM must set limits no higher than those prescribed by the Commission.[795] The Dodd-Frank

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[792] See discussion above.

[793] CEA section 5(d)(5) (specifying DCM core principle 5 titled "Position Limits or Accountability").

[794] Specifically, in 2001, the Commission adopted in part 38 app. B (Guidance on, and acceptable Practices in, Compliance with Core Principles), 66 FR 42256, 42280, Aug. 10, 2001, an acceptable practice for compliance with DCM core principle 5 that stated "[p]rovisions concerning speculative position limits are set forth in part 150." Current § 150.5 states that each DCM shall "limit the maximum number of contracts a person may hold or control, separately or in combination, net long or net sort, for the purchase or sale of a commodity for future delivery or, on a futures-equivalent basis, options thereon," with certain exemptions. Exemptions from federal limits include major foreign currencies and "spread, straddles or arbitrage" exemptions. Current § 150.5 expressly excludes bona fide hedging positions from limits, but acknowledges that exchanges may limit positions "not in accord with sound commercial practices or exceed an amount which may be established and liquidated in an orderly fashion."

[795] Dodd-Frank Act section 735(b). CEA section 4a(e), effective prior to, and not amended by, the Dodd-Frank Act, likewise provides that position limits fixed by a board of trade not exceed federal limits. 7 U.S.C. 6a(e).

Act also added parallel core principle obligations on newly-authorized SEFs, including SEF core principle 6 regarding the establishment of position limits.[796]

i. Rule summary

In light of these Dodd-Frank Act statutory amendments, the Commission proposes to amend §150.5 to specify certain binding requirements with which DCMs and SEFs must comply in establishing exchange-set limits.[797] Specifically, proposed § 150.5(a)(1) would require that DCMs and SEFs set limits for contracts listed in § 150.2(d) at a level not higher than the levels specified in § 150.2. Proposed § 150.5(a)(5) and (b)(8) would require that exchanges adopt aggregation rules that conform to proposed § 150.4 for all contracts, including those contracts subject to federal speculative limits. Proposed § 150.5(a)(2)(i) and (b)(5)(i) would require that exchanges conform their bona fide hedging exemption rules to the proposed § 150.1 definition of bona fide hedging for all contracts, including those contracts subject to federal speculative limits. Proposed § 150.5(a)(2)(iii) and (b)(5)(iii) would require that exchanges condition any exemptive relief from federal or exchange-set position limits on an application from the trader.[798] To the extent an exchange offers exemptive relief for intra- and inter-market spread positions for contracts subject to federal limits under proposed § 150.2, proposed § 150.5(a)(2)(i) and (ii) would require that the exchange provide such relief only outside of

[796] Dodd-Frank Act section 733 (adding CEA section 5h; 7 U.S.C. 7b-3).

[797] As discussed above, proposed § 150.5 also would continue to incorporate non-exclusive guidance and acceptable practices for DCMs and SEFs with respect to setting limits with and without a measurable deliverable supply, adopting position accountability in lieu of a position limits scheme, and adjusting limit levels, among other things. As non-binding guidance and acceptable practices, these components of the rulemaking are not binding Commission regulations or orders subject to the requirement of CEA section 15(a).

[798] The Commission notes that for contracts subject to federal limits, exchange-granted exemptions would need to conform with the standards in proposed § 150.5(a)(2)(i) for hedge exemptions and proposed § 150.5(a)(2)(ii) for other exemptions.

the spot month for physical-delivery contracts and, with respect to intra-market spread positions, on the condition that such positions do not exceed the all-months limit. Finally, proposed § 150.5(a)(4) would further implement the statutory provision in CEA section 4a(b)(2) that exempts pre-existing positions, while § 150.5(a)(3) would require exchanges to mirror the Commission's exemption in proposed § 150.3 for pre-enactment and transition period swaps from exchange-set limits on contracts subject to limits under proposed § 150.2. Proposed § 150.5(a)(3) would also require exchanges to allow the netting of pre-enactment and transition swaps with post-effective date commodity derivative contracts for the purpose of complying with any non-spot-month position limit.

Two of these proposed requirements — i.e., that for contracts subject to limits specified in § 150.2, DCMs and SEFs set limits no higher than those specified in § 150.2, and that pre-existing positions must be exempted from exchange-set limits on contracts subject to § 150.2 — exclusively codify statutory requirements, and therefore reflect no exercise of Commission discretion subject to CEA section 15(a). The other-listed requirements, however, do involve Commission discretion, the costs and benefits of which are considered below.

ii. Benefits

Functioning as an integrated component within the broader position-limits regulatory regime, the Commission expects the proposed changes to § 150.5 would further the four objectives outlined in CEA section 4a(a)(3).[799] As explained more fully below, the Commission believes these proposed amendments offer significant benefits.

a. Section 150.5(a)(5) and (b)(8) aggregation

[799] CEA section 4a(a)(3)(B) applies for purposes of setting federal limit levels. 7 U.S.C. 6a(a)(3)(B). The Commission considers the four factors set out in the section relevant for purposes of considering the benefits and costs of these proposed amendments addressed to exchange-set position limits as well.

CEA section 4a(a)(1) states that the Commission, "[in] determining whether any person has exceeded such limits," must include "the positions held and trading done by any persons directly or indirectly controlled" by such person. Pursuant to this statutory direction, the Commission has proposed in a separate release amendments to its aggregation policy, located in § 150.4.[800] The regulations proposed in this release require that exchange-set limits employ aggregation policies that conform to the Commission's aggregation policy both for contracts that are subject to federal limits under § 150.2 and those that are not, thus harmonizing aggregation rules for all federal and exchange-set speculative position limits.

For contracts subject to federal speculative position limits under proposed § 150.2, the Commission anticipates that a harmonized approach to aggregation will prevent confusion that otherwise might result from allowing divergent standards between federal and exchange-set limits on the same contracts. Further, the proposed approach would prevent the kind of regulatory arbitrage that may impede the benefits of the federal speculative position limits regime. The harmonized approach to aggregation policies for limits on all levels eliminates the potential for exchanges to use permissiveness in aggregation policies as a competitive advantage and therefore prevents a "race to the bottom," which would impair the effectiveness of the Commission's aggregation policy. In addition, DCMs and SEFs are required to set position limits at a level not higher than that set by the Commission. Differing aggregation standards may have the practical effect of lowering a DCM- or SEF-set limit to a level that is lower than that set by the Commission. Accordingly, harmonizing aggregation standards reinforces the efficacy and

[800] See Aggregation NPRM.

intended purpose of §§ 150.5(a)(2)(iii) and (b)(5)(iii) by foreclosing an avenue to circumvent applicable limits.

Moreover, by extending this harmonized approach to contracts not included in proposed § 150.2, the Commission is proposing a common standard for all federal and exchange-set limits. The proposed rule provides uniformity, consistency, and certainty for traders who are active on multiple trading venues, and thus should reduce the administrative burden on traders as well as the burden on the Commission in monitoring the markets under its jurisdiction.

b. <u>Section 150.5(a)(2)(i) and (b)(5)(i) hedge exemptions</u>

The proposed rules also promote a common standard for bona fide hedging exemptions by requiring such exemptions granted by an exchange to conform with the proposed definition of bona fide hedging in § 150.1. For contracts subject to federal limits under proposed § 150.2, the proposed rules under § 150.5(a)(2)(i) prescribe a harmonized approach intended to prevent the confusion that may arise should the same contract have differing standards of bona fide hedging between the Commission's federal standard and the standard on any given exchange. As discussed above, the definition of bona fide hedging proposed by the Commission in this release allows only positions that represent legitimate commercial risk to be exempt from position limits. Deviation from this definition could impede the effectiveness of the Commission's position limit regime by potentially allowing positions to be improperly exempted from speculative limits.

Proposed § 150.5(b)(5)(i) would extend this common standard of bona fide hedging to contracts not subject to federal speculative limits, thereby creating a single standard across all trading venues that would reduce the administrative burden on market

participants trading on multiple trading venues and the burden on the Commission of monitoring the markets under its jurisdiction.

c. Section 150.5(a)(2)(iii) and (b)(5)(iii) application for exemption

Proposed § 150.5 requires traders to apply to the exchange for any exemption from position limits. Requiring traders to apply to the exchange affirms the position of the DCM or SEF as the front-line regulator for position limits while providing the exchanges with information that can be used to ensure the legitimacy of a trader's position with regards to its eligibility for exemptive relief. By gathering information from traders' applications for exemption, exchanges will have a complete record of all exemptions requested, granted, and denied, as well as information about the commercial operations of traders who apply for exemptions. Because the Commission has not specified a format for such exemption applications, exchanges have flexibility to determine which information will best inform the exchange's self-regulatory operations and obligations.

The Commission understands that many DCMs are already requiring applications for exemptive relief from speculative position limits,[801] and that SEFs are likely to adopt this practice as a "best practice" for complying with core principles. As such, the proposed rules codify an industry "best practice" regarding position limits and promote the continuation of the benefits of that best practice across all trading venues and all commodity derivative contracts.

d. Section 150.5(a)(2)(ii) other exemptions

[801] See, e.g., CME Rule 559; NYMEX Rule 559; CBOT Rule 559; KCBT Rule 559; ICE Futures Rules 6.26, 6.27, and 6.29; and MGEX Rule 1504.00.

As discussed above, the Commission is proposing to set single-month limits at the same levels as all-months limits, rendering the "spread" exemption in current § 150.3 unnecessary. However, since DCM core principle 5 allows exchanges to set more restrictive levels than those set by the Commission, a DCM or SEF may set the single month limit at a lower level than that of the all-month limit. Further, because federal limits apply across trading venues, exchanges may grant spread exemptions for inter-market spreads across exchanges. As such, the Commission is proposing § 150.5(a)(2)(ii) to clarify the types of spread positions for which a DCM or SEF may grant exemptions by cross-referencing the definitions proposed in § 150.1[802] and to require that any such exemption be outside of the spot month for physical-delivery contracts.

This exemption would provide exchanges with certainty regarding the application of spread exemptions for contracts subject to federal limits under proposed § 150.2. Should an exchange decide to provide exemptive relief for spread positions, the exemption described in § 150.5(a)(2)(ii) promotes the intended goals of federal speculative limits, including protection of the spot period in the physical-delivery contract and exemption of positions as appropriate.

e. <u>Section 150.5(a)(3) pre-enactment and transition period swaps positions</u>

Proposed § 150.5(a)(3) requires DCMs and SEFs to exempt pre-enactment and transition period swaps as defined in proposed § 150.1 from exchange-set limits on contracts subject to federal limits under proposed § 150.2. This provision mirrors the exemption proposed in § 150.3 and requires that exchanges provide the same relief as the Commission for pre-existing swaps positions.

[802] The terms "inter-market spread" and "intra-market spread" are defined in proposed § 150.1.

Further, requiring that DCMs and SEFs allow netting of pre-and-post enactment swaps outside of the spot month provides additional flexibility on an exchange level for market participants in transitioning to a position limits regime that includes swaps.

f. Request for comment

The Commission requests comment on its consideration of the benefits of proposed § 150.5. Are there additional benefits that the Commission should consider? Has the Commission misidentified any benefits?

iii. Costs

DCMs presently have considerable experience in setting and administering speculative position limits and hedge exemption programs in line with existing Commission guidance and acceptable practices that run parallel in most respects to the requirements that are incorporated in the proposed rule. Accordingly, as a general matter, the Commission anticipates minimal cost impact on DCMs from these proposed requirements; relative to DCMs, the cost impact for SEFs as newly-instituted entities may be somewhat greater.

The Commission notes that recently adopted § 37.204 of the Commission's regulations allows SEFs the flexibility to contract with a third-party regulatory service provider[803] to fulfill certain regulatory obligations.[804] The administration of position limits is within the range of obligations eligible for outsourcing to a third-party regulatory service provider. Presumably, a SEF will avail itself of this flexibility if doing so results in lower costs for the entity. In order to better inform itself with respect to the cost

[803] Under § 37.204, possible third-party regulatory service providers include registered futures associations (such as the National Futures Association (NFA)), registered entities (such as DCMs or SEFs), and the Financial Industry Regulatory Authority (FINRA).

[804] See 78 FR 33476, 33516, Jun. 4, 2013.

implications of this proposed rule for SEFs, the Commission requests comment on the likelihood of SEFs utilizing a third-party regulatory service provider to comply with its position limits obligations and the expected dollar costs of doing so. The Commission also requests comment on the expected dollar costs of meeting the proposed rule's requirement if a SEF undertakes to perform the proposed rule's obligations in-house rather than outsourcing them.

The following discusses potential costs with respect to the specific discretionary aspects of the rule to which they are attributable.

a. Section 150.5(a)(5) and (b)(8) aggregation and § 150.5(a)(2)(i) and (b)(5)(i) hedge exemptions

DCMs may incur costs to amend their current aggregation and bona fide hedging policies to conform with proposed § 150.4 and proposed § 150.1 respectively. Such costs may include burdens associated with reviewing and evaluating current standards to assess differences that must be addressed, employing legal counsel to aid in ensuring conformity, and transitioning from an old standard to the new one. Because the burden associated with this rule is proportional to the divergence of a DCM's current standard from the Commission's proposed standard, costs are specific and proprietary to each affected entity; as such, the Commission is unable to estimate costs at this time within a range of reasonable accuracy. It requests comment to assist it in doing so.

SEFs, as newly-instituted entities, will be required to incur costs to develop aggregation and bona fide hedging policies that conform to the appropriate provisions as required under proposed § 150.5. Such costs are likely to include legal counsel, as well as drafting and implementation of the new policy. Because these entities are new and

have not previously been subject to the Commission's oversight in this capacity, the Commission requests comment regarding the costs associated with implementing the appropriate policies.

b. <u>Section 150.5(a)(2)(iii) and (b)(5)(iii) application for exemption</u>

The Commission anticipates that DCMs will incur minimal costs to administer the application process for exemption relief in accordance with standards set forth in the proposed rule. As described above, the Commission understands that requiring traders to apply for exemptive relief comports with existing DCM practice. Accordingly, by incorporating an application requirement that the Commission has reason to understand most if not all active DCMs already follow, the rule should have little cost impact for DCMs.

For SEFs, the rules necessitate a compliant application regime, which will require an initial investment similar to that which DCMs have likely already made and need not duplicate. As noted above, the Commission considers it highly likely that, in accordance with industry best practices to comply with core principles and due to the utility of application information in demonstrating compliance with core principles, SEFs may incur such costs with or without the proposed rules. Again, due to the new existence of these entities, the Commission is unable to estimate what costs may be associated with the requirement to impose an application regime for exemptive relief on the exchange level. The Commission requests comment regarding the burden on a SEF to impose a compliant application regime.

c. <u>Section 150.5(a)(2)(ii) other exemptions</u>

Proposed § 150.5(a)(2)(ii) provides clarity on the imposition of exemptions for spread positions on contracts subject to federal limits under proposed § 150.2 in accordance with new definitions proposed in § 150.1. The Commission notes again that the rules would apply if the single-month limit is at a lower level than the all-month limit, which would occur if a DCM or SEF determines to set more restrictive levels for a single-month limit that what has been set by the Commission, or if the exchange grants inter-market spread exemptions. Thus, the Commission anticipates that a DCM or SEF that has determined to set a more restrictive limit will have done so having taken into account any burden imposed by the proposed rule. Further, some trading venues already grant inter-market spread exemptions on certain commodities; such entities may be able to leverage current practices to extend such spread exemptions to other commodities as appropriate.

The Commission expects small costs to be associated with communicating and monitoring the appropriate conditions for exemption as described in proposed § 150.5(a)(2)(ii), namely that such position must be solely outside of the spot-month of the physical-delivery contract.

d. <u>Request for comment</u>

The Commission requests comment on its considerations of the costs of proposed § 150.5. Are there additional costs that the Commission should consider? Has the Commission misidentified any costs? What other relevant cost information or data, including alternative cost estimates, should the Commission consider and why?

iv. <u>Consideration of alternatives</u>

The Commission recognizes that alternatives may exist to discretionary elements of § 150.5 proposed herein. The Commission requests comment on whether an alternative to what is proposed would result in a superior benefit-cost profile, with support for any such position provided.

6. Section 150.7 – Reporting requirements for anticipatory hedging positions

The revised definition of bona fide hedging in proposed § 150.1 incorporates hedges of five specific types of anticipated transactions: unfilled anticipated requirements, unsold anticipated production, anticipated royalties, anticipated services contract payments or receipts, and anticipatory cross-hedges.[805] The Commission proposes reporting requirements in new § 150.7 for traders seeking an exemption from position limits for any of these five enumerated anticipated hedging transactions. Proposed § 150.7 would build on, and replace, the special reporting requirements for hedging of unsold anticipated production and unfilled anticipated requirements in current § 1.48.[806]

Current § 1.48 provides a procedure for persons to file for bona fide hedging exemptions for anticipated production or unfilled requirements when that person has not covered the anticipatory need with fixed-price commitments to sell a commodity, or inventory or fixed-price commitments to purchase a commodity. It reflects a long-standing Commission concern for the difficulty of distinguishing between reduction of risk arising from anticipatory needs and that arising from speculation if anticipatory

[805] See, paragraphs (3)(iii), (4)(i), (iii), and (iv), and (5), respectively, of the Commission's amended definition of bona fide hedging transactions in proposed § 150.1.
[806] See 17 CFR 1.48. See also definition of bona fide hedging transactions in current 17 CFR 1.3(z)(2)(i)(B) and (ii)(C), respectively.

transactions are not well defined.[807] These same concerns apply to any position undertaken to reduce the risk of anticipated transactions. To address them, the Commission proposes to extend the special reporting requirements in proposed § 150.7 for all types of enumerated anticipatory hedges that appear in the definition of bona fide hedging positions in proposed § 150.1.[808]

The Commission proposes to add a new series '04 reporting form, Form 704, to effectuate these additional and updated reporting requirements for anticipatory hedges. Persons wishing to avail themselves of an exemption for any of the anticipatory hedging transactions enumerated in the updated definition of bona fide hedging in proposed § 150.1 would be required to file an initial statement on Form 704 with the Commission at least ten days in advance of the date that such positions would be in excess of limits established in proposed § 150.2.

Proposed § 150.7(f) would add a requirement for any person who files an initial statement on Form 704 to provide annual updates that detail the person's actual cash market activities related to the anticipated exemption. Proposed § 150.7(g) would similarly enable the Commission to review and compare the actual cash activities and the remaining unused anticipated hedge transactions by requiring monthly reporting on Form 204.

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[807] See Hedging Anticipated Requirements for Processing or Manufacturing under Section 4a(3) of the Commodity Exchange Act, 21 FR 6913, Sep. 12, 1956.

[808] For purposes of simplicity, the proposed special reporting requirements for anticipatory hedges would be placed within the Commission's position limits regime in part 150, and alongside the Commission's updated definition of bona fide hedging positions in proposed § 150.1; rendered duplicative by these changes, current § 1.48 would be deleted. In another non-substantive change, proposed § 150.7(i) would replace current § 140.97 which delegates to the Director of the Division of Market Oversight or his designee authority regarding requests for classification of positions as bona fide hedging under current §§ 1.47 and 1.48. For purposes of simplicity, this delegation of authority would be placed within the Commission's position limits regime in part 150.

As is the case under current § 1.48, proposed § 150.7(h) requires that a trader's maximum sales and purchases must not exceed the lesser of the approved exemption amount or the trader's current actual anticipated transaction.

i. <u>Benefits and costs</u>

As noted above, the Commission remains concerned that distinguishing whether an over-the-limit position is entered into in order to reduce risk arising from anticipatory needs, or whether it is speculative, may be exceedingly difficult if anticipatory transactions are not well defined. The Commission proposes to add, in its discretion, proposed § 150.7 to collect vital information to aid in this distinction. Advance notice of a trader's intended maximum position in commodity derivative contracts to offset anticipatory risks would identify — in advance — a position as a bona fide hedging position, avoiding unnecessary contact during the trading day with surveillance staff to verify whether a hedge exemption application is in process, the appropriate level for the exemption and whether the exemption is being used in a manner that is consistent with the requirements. Market participants can anticipate hedging needs well in advance of assuming positions in derivatives markets and in many cases need to supply the same information after the fact; in such cases, providing the information in advance allows the Commission to better direct its efforts towards deterring and detecting manipulation. The annual updates in proposed § 150.7(f) similarly allow the Commission to verify on an ongoing basis that the person's anticipated cash market transactions closely track that person's real cash market activities. Absent monthly filing pursuant to proposed § 150.7(g), the Commission would need to issue a special call to determine why a person's

commodity derivative contract position is, for example, larger than the pro rata balance of her annually reported anticipated production.

The Commission understands that there will be costs associated with proposed § 150.7(f) in the filing of Form 704. Costs of filing that form are discussed in the context of the proposed part 19 requirements.

The Commission requests comments on its consideration of the costs and benefits of proposed § 150.7. Are there additional costs or benefits the Commission should consider? What costs may be incurred beyond those incurred to gather information and file Form 704? Should the Commission consider alternatives to its annual updating requirement? The Commission also recognizes that alternatives may exist to discretionary elements of § 150.7 proposed herein. The Commission requests comments on whether an alternative to what is proposed would result in a superior benefit-cost profile, with support for any such position provided.

7. <u>Part 19 – Reports</u>

CEA Section 4i authorizes the Commission to require the filing of reports, as described in CEA section 4g, when positions equal or exceed position limits. Current part 19 of the Commission's regulations sets forth these reporting requirements for persons holding or controlling reportable futures and option positions that constitute bona fide hedge positions as defined in § 1.3(z) and in markets with federal speculative position limits — namely those for grains, the soy complex, and cotton. Since having a bona fide hedge exemption affords a commercial market participant the opportunity to hold positions that exceed a position limit level, it is important for the Commission to be able to verify that when an exemption is invoked that it is done so for legitimate

purposes. As such, commercial entities that hold positions in excess of those limits must file information on a monthly basis pertaining to owned stocks and purchase and sales commitments for entities that claim a bona fide hedging exemption.

In order to help ensure that the additional exemptions described in proposed § 150.3 are used in accordance with the requirements of the exemption employed, as well as obtain information necessary to verify that any futures, options and swaps positions established in referenced contracts are justified, the Commission proposes to make conforming and substantive amendments to part 19. First, the Commission proposes to amend part 19 by adding new and modified cross-references to proposed part 150, including the new definition of bona fide hedging position in proposed § 150.1.[809] Second, the Commission proposes to amend § 19.00(a) by extending reporting requirements to any person claiming any exemption from federal position limits pursuant to proposed § 150.3. The Commission proposes to add three new series '04 reporting forms to effectuate these additional reporting requirements. Third, the Commission proposes to update the manner of part 19 reporting. Lastly, the Commission proposes to update both the type of data that would be required in series '04 reports, as well as the time allotted for filing such reports.

i. <u>Rule summary</u>

a. <u>Extension of reporting requirements</u>

Proposed part 19 will be expanded to include reporting requirements for positions in swaps, in addition to futures and options positions, for any instance in which a person relies on an exemption. Therefore, positions in "commodity derivative contracts," as

[809] These amendments are non-substantive conforming amendments and should not have implications for the Commission's consideration of costs and benefits.

defined in proposed § 150.1, would replace "futures and option positions" throughout amended part 19 as shorthand for any futures, option, or swap contract in a commodity (other than a security futures product as defined in CEA section 1a(45)).[810]

The Commission also proposes to extend the reach of part 19 by requiring all persons who avail themselves of any exemption from federal position limits under proposed § 150.3 to file applicable series '04 reports.[811] The list of positions set forth in proposed § 150.3 that are eligible for exemption from the federal position includes, but is not limited to, bona fide hedging positions (including pass-through swaps and anticipatory bona fide hedge positions), qualifying spot month positions in cash-settled referenced contracts, and qualifying non-enumerated risk-reducing transactions.

The Commission currently requires two monthly reports, CFTC Forms 204 and 304, which are listed in current § 15.02.[812] The reports, collectively referred to as the Commission's "series '04 reports," show a trader's positions in the cash market and are used by the Commission to determine whether a trader has sufficient cash positions that justify futures and option positions above the speculative limits. CFTC Form 204 is the Statement of Cash Positions in Grains, which includes the soy complex, and CFTC Form 304 Report is the Statement of Cash Positions in Cotton.[813] The Commission proposes to add three new series '04 reporting forms to effectuate the expanded reporting requirements of part 19. Proposed CFTC Form 504, Statement of Cash Positions for Conditional Spot Month Exemptions, would be added for use by persons claiming the

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[810] See supra discussion of proposed amendments to part 19.

[811] Furthermore, anyone exceeding the federal limits who has received a special call must file a series '04 form.

[812] 17 CFR 15.02.

[813] See supra discussion of series '04 forms.

conditional spot month limit exemption pursuant to proposed § 150.3(c). Proposed CFTC Form 604, Statement of Counterparty Data for Pass-Through Swap Exemptions, would be added for use by persons claiming a bona fide hedge exemption for either of two specific pass-through swap position types, as discussed further below. Proposed CFTC Form 704, Statement of Anticipatory Bona Fide Hedge Exemptions, would be added for use by persons claiming a bona fide hedge exemption for certain anticipatory bona fide hedging positions.

b. Manner of reporting

For purposes of reporting cash market positions under current part 19, the Commission historically has allowed a reporting trader to "exclude certain products or byproducts in determining his cash positions for bona fide hedging" if it is "the regular business practice of the reporting trader" to do so.[814] Nevertheless, the Commission believes that an entity, when calculating the value that is subject to risks from a source commodity in order to establish a long derivatives position as a hedge for unfilled anticipated requirements, need take into account large quantities of a source commodity that it may hold in inventory. Under proposed § 19.00(b)(1), a source commodity itself can only be excluded from a calculation of a cash position if the amount is de minimis, impractical to account for, and/or on the opposite side of the market from the market participant's hedging position.[815]

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[814] See 17 CFR 19.00(b)(1) (providing that "[i]f the regular business practice of the reporting trader is to exclude certain products or byproducts in determining his cash position for bona fide hedging . . . , the same shall be excluded in the report").

[815] Proposed § 19.00(b)(1) adds a caveat to the alternative manner of reporting: when reporting for the cash commodity of soybeans, soybean oil, or soybean meal, the reporting person shall show the cash positions of soybeans, soybean oil and soybean meal. This proposed provision for the soybean complex is included in the current instructions for preparing Form 204.

Persons who wish to avail themselves of cross-commodity hedges are required to file an appropriate series '04 form. Proposed § 19.00(b)(2) sets forth instructions, which are consistent with the provisions in the current section, for reporting a cash position in a commodity that is different from the commodity underlying the futures contract used for hedging.[816] Since proposed § 19.00(b)(3) would maintain the requirement that cross-hedged positions be shown both in terms of the equivalent amount of the commodity underlying the commodity derivative contract used for hedging and in terms of the actual cash commodity (as provided for on the appropriate series '04 form), the Commission will be able to determine the hedge ratio used merely by comparing the reported positions. Thus, the Commission will be positioned to review whether a hedge ratio appears reasonable in comparison to, for example, other similarly situated traders.

Proposed § 19.00(b)(3) maintains the requirement that standards and conversion factors used in computing cash positions for reporting purposes must be made available to the Commission upon request. Proposed § 19.00(b)(3) would clarify that such information would include hedge ratios used to convert the actual cash commodity to the equivalent amount of the commodity underlying the commodity derivative contract used for hedging, and an explanation of the methodology used for determining the hedge ratio.

c. <u>Bona fide hedgers and cotton merchants and dealers</u>

Current § 19.01(a) sets forth the data that must be provided by bona fide hedgers (on Form 204) and by merchants and dealers in cotton (on Form 304). The Commission proposes to continue using Forms 204 and 304, with minor changes to the types of data to

[816] Proposed § 19.00(b)(2) would add the term commodity derivative contracts (as defined in proposed § 150.1). The proposed definition of cross-commodity hedge in proposed § 150.1 is discussed <u>above</u>.

be reported.[817] Form 204 will be expanded to incorporate, in addition to all other positions reportable under proposed § 19.00(a)(1)(iii), monthly reporting for cotton, including the granularity of equity, certificated and non-certificated cotton stocks of cotton. Weekly reporting for cotton will be retained as a separate report made on Form 304 for the collection of data required by the Commission to publish its weekly public cotton "on call" report on www.cftc.gov.

Proposed § 19.01(b) would maintain the requirement that reports on Form 204 be submitted to the Commission on a monthly basis, as of the close of business on the last Friday of the month.

d. <u>Conditional spot-month limit exemption</u>

Proposed § 19.01(a)(1) would require persons availing themselves of the conditional spot month limit exemption for natural gas (pursuant to proposed § 150.3(c)) to report certain detailed information concerning their cash market activities. While traders could not directly influence the settlement price in the physical-delivery referenced contract due to the prohibition of holding physical-delivery contract positions when invoking the conditional spot month exemption, there is no similar restriction on holding the underlying cash commodity. While the Commission is concerned about traders' activities in the underlying cash market of any derivative contract, it is particularly concerned with respect to natural gas where there is an existing conditional spot-month limit exemption. Accordingly, proposed § 19.01(b) would require that persons claiming a conditional spot month limit exemption must report on new Form 504 daily, by 9 a.m. Eastern Time on the next business day, for each day that a person is over

[817] The list of data required for persons filing on Forms 204 and 304 would be relocated from current § 19.01(a) to proposed § 19.01(a)(3).

the spot month limit in certain commodity contracts specified by the Commission. The scope of reporting — purchase and sales contracts through the delivery area for the core referenced futures contract and inventory in the delivery area — differs from the scope of reporting for bona fide hedgers, since the person relying on the conditional spot month limit exemption need not be hedging a position.

Initially, the Commission would require reporting on new Form 504 for exemptions in the natural gas commodity derivative contracts only.[818] The Commission requests comment as to whether the costs and benefits of the enhanced reporting regime support imposing this requirement on additional commodity markets before gaining additional experience with this exemption in other commodities.

e. Pass-through swap exemption

Under the definition of bona fide hedging position in proposed § 150.1, a person who uses a swap to reduce risks attendant to a position that qualifies for a bona fide hedging transaction may pass-through those bona fides to the counterparty, even if the person's swap position is not in excess of a position limit.[819] As such, positions in commodity derivative contracts that reduce the risk of pass-through swaps would qualify as bona fide hedging transactions.

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[818] The Commission believes that enhanced reporting for natural gas contracts is warranted based on its experience in surveillance of natural gas commodity derivative contracts. Absent experiential evidence of current need beyond the natural gas realm, the Commission proposes to initially not impose reporting requirements for persons claiming conditional spot month limit exemptions in other commodity derivative contracts until the Commission gains additional experience with the limits in proposed § 150.2. However, the Commission retains its authority to issue "special calls" under § 18.05. The Commission will closely monitor the reporting associated with conditional spot-month limit exemptions in natural gas, as well as other information available to the Commission for other commodities, and may require reporting on Form 504 for other commodity derivative contracts in the future.

[819] See supra discussion of definition of bona fide hedging position in proposed § 150.1.

Proposed § 19.01(a)(2) would require a person relying on the pass-through swap exemption who holds either of two position types to file a report with the Commission on new form 604. The first type of position is a swap executed opposite a bona fide hedger that is not a referenced contract and for which the risk is offset with referenced contracts. The second type of position is a cash-settled swap executed opposite a bona fide hedger that is offset with physical-delivery referenced contracts held into a spot month, or, vice versa, a physical-delivery swap executed opposite a bona fide hedger that is offset with cash-settled referenced contracts held into a spot month.

The information reported on Form 604 would explain hedgers' needs for large referenced contract positions and would give the Commission the ability to verify that the positions were a bona fide hedge, with heightened daily surveillance of spot month offsets. Persons holding any type of pass-through swap position other than the two described above would report on form 204.[820]

f. <u>Swap off-sets</u>

Proposed § 19.01(a)(2)(i) lists the types of data that a person who executes a pass-through swap that is not a referenced contract and for which the risk is offset with referenced contracts must report on new Form 604. Under proposed § 19.01(b), persons holding non-referenced contract swap offset would submit reports to the Commission on a monthly basis, as of the close of business of the last Friday of the month. This data collection would permit staff to identify offsets of non-referenced-contract pass-through swaps on an ongoing basis for further analysis.

[820] Persons holding pass-through swap positions that are offset with referenced contracts outside the spot month (whether such contracts are for physical delivery or are cash-settled) need not report on Form 604 because swap positions will be netted with referenced contract positions outside the spot month pursuant to proposed § 150.2(b).

Under proposed § 150.2(a), a trader in the spot month may not net across physical-delivery and cash-settled contracts for the purpose of complying with federal position limits.[821] If a person executes a cash-settled pass-through swap that is offset with physical-delivery contracts held into a spot month (or vice versa), then, pursuant to proposed § 19.01(a)(2)(ii), that person must report additional information concerning the swap and offsetting referenced contract position on new Form 604. Pursuant to proposed § 19.01(b), a person holding a spot month swap offset would need to file on form 604 as of the close of business on each day during a spot month, and not later than 9 a.m. Eastern Time on the next business day following the date of the report. The Commission notes that pass-through swap offsets would not be permitted during the lesser of the last five days of trading or the time period for the spot month. However, the Commission remains concerned that a trader could hold an extraordinarily large position early in the spot month in the physical-delivery contract along with an offsetting short position in a cash-settled contract. Hence, the Commission proposes to introduce this new daily reporting requirement within the spot month to identify and monitor such offsetting positions.

ii. Benefits

The reporting requirements allow the Commission to obtain the information necessary to verify whether the relevant exemption requirements are fulfilled in a timely manner. This is needed for the Commission to help ensure that any person who claims any exemption from federal speculative position limits can demonstrate a legitimate purpose for doing so. In the absence of the reporting requirements detailed in proposed

[821] See supra discussion of proposed § 150.2.

part 19, the Commission would lack critical tools to identify abuses related to the exemptions afforded in proposed § 150.3 in a timely manner and refer them to enforcement. As such, the reporting requirements are necessary for the Commission to be able to perform its essential surveillance functions. These reporting requirements therefore promote the Commission's ability to achieve, to the maximum extent practicable, the statutory factors outlined by Congress in CEA section 4a(a)(3).

The Commission requests comment on its considerations of the benefits of reporting under part 19. Has the Commission accurately identified the benefits of collecting the reported information? Are there additional benefits the Commission should consider?

iii. <u>Costs</u>

The Commission recognizes there will be costs associated with the proposed changes and additions to the report filing requirements under part 19. Though the Commission anticipates that market participants should have ready access to much of the required information, the Commission expects that, at least initially, market participants will require additional time and effort to become familiar with new and amended series '04 forms, to gather the necessary information in the required format, and to file reports in the proposed timeframes. The Commission has attempted to mitigate the cost impacts of these reports.

Actual costs incurred by market participants will vary depending on the diversity of their cash market positions, the experience that the participants currently have regarding filing Form 204 and Form 304 as well as a variety of other organizational

factors. However, the Commission has estimated average incremental burdens associated with the proposed rules in order to fulfill its obligations under the PRA.[822]

For Form 204, the Commission estimates that approximately 400 market participants will file an average of 12 reports annually at an estimated labor burden of 2 hours per response for a total per-entity hour burden of approximately 24 hours, which computes to a total annual burden of 9,600 hours for all affected entities. Using an estimated hourly wage of $120 per hour,[823] the Commission estimates an annual per-entity cost of approximately $2,900 and a total annual cost of $1,152,000 for all affected entities.

For Form 304, the Commission estimates that approximately 400 market participants will file an average of 52 reports annually at an estimated labor burden of 1 hours per response for a total per-entity hour burden of approximately 52 hours, which computes to a total annual burden of 20,800 hours for all affected entities. Using an estimated hourly wage of $120 per hour,[824] the Commission estimates an annual per-entity cost of approximately $6,300 and a total annual cost of $2,500,000 for all affected entities.

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[822] See PRA section below for full details on the Commission's estimates.

[823] The Commission's estimates concerning the wage rates are based on 2011 salary information for the securities industry compiled by the Securities Industry and Financial Markets Association ("SIFMA"). The Commission is using $120 per hour, which is derived from a weighted average of salaries across different professions from the SIFMA Report on Management & Professional Earnings in the Securities Industry 2011, modified to account for an 1800-hour work-year, adjusted to account for the average rate of inflation in 2012, and multiplied by 1.33 to account for benefits and 1.5 to account for overhead and administrative expenses. The Commission anticipates that compliance with the provisions would require the work of an information technology professional; a compliance manager; an accounting professional; and an associate general counsel. Thus, the wage rate is a weighted national average of salary for professionals with the following titles (and their relative weight); "programmer (senior)" and "programmer (non-senior)" (15% weight), "senior accountant" (15%) "compliance manager" (30%), and "assistant/associate general counsel" (40%). All monetary estimates have been rounded to the nearest hundred dollars.

[824] Id.

For the new Form 504, the Commission anticipates that approximately 40 market participants will file an average of 12 reports annually at an estimated labor burden of 15 hours per response for a total per-entity hour burden of approximately 180 hours, which computes to a total annual burden of 7,200 hours for all affected entities. Using an estimated hourly wage of $120 per hour,[825] the Commission estimates an annual per-entity cost of approximately $10,800 and a total annual cost of $864,000 for all affected entities.

For the new Form 604, the Commission anticipates that approximately 200 market participants will file an average of 10 reports annually at an estimated labor burden of 30 hours per response for a total per-entity hour burden of approximately 300 hours, which computes to a total annual burden of 60,000 hours for all affected entities. Using an estimated hourly wage of $120 per hour,[826] the Commission estimates an annual per-entity cost of approximately $36,000 and a total annual cost of $7,200,000 for all affected entities.

Finally, for the new Form 704, the Commission anticipates that approximately 200 market participants will file an average of 10 reports annually at an estimated labor burden of 20 hours per response for a total per-entity hour burden of approximately 200 hours, which computes to a total annual burden of 40,000 hours for all affected entities. Using an estimated hourly wage of $120 per hour,[827] the Commission estimates an annual per-entity cost of approximately $24,000 and a total annual cost of $4,800,000 for all affected entities.

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[825] Id.

[826] Id.

[827] Id.

The Commission requests comment regarding its consideration of costs pertaining to the amendments to part 19. Has the Commission accurately described the ways that market participants may incur costs? Are there other costs, direct or indirect, that the Commission should consider regarding the proposed part 19? How does the introduction of the new series '04 reports affect the likelihood that a trader may seek an exemption? What other burdens may arise from the filing of these reports? Are the Commission's burden estimates under the PRA reasonable? Why or why not? Commenters are encouraged to submit their own estimates of costs, including labor burdens and wage estimates, for the Commission's consideration.

iv. <u>Consideration of alternatives</u>

The Commission also recognizes that alternatives may exist to discretionary elements of the part 19 reporting amendments proposed herein. The Commission requests comments on whether an alternative to what is proposed would result in a superior benefit-cost profile, with support for any such position provided.

8. <u>CEA section 15(a)</u>

As described above, the Commission interprets the revised CEA section 4a as requiring the imposition of speculative position limits during the spot-month, any single month, and all-months-combined on all commodity derivative contracts, including swaps, that reference the same underlying physical commodity on an aggregated basis across trading venues. Section 15(a) of the Act requires the Commission to evaluate the costs and benefits of its discretionary actions in light of five enumerated factors that represent broad areas of market and public concern. The Commission welcomes comment on its evaluation under CEA section 15(a).

i. Protection of market participants and the public

Broadly speaking, the Commission's expansion of the federal speculative position limits regime to include an additional 19 core-referenced futures contracts (and the associated referenced contracts) will extend protections afforded to the existing legacy contracts. Namely, the limits are intended as a measure to prophylactically deter manipulation and to diminish, eliminate, or prevent excessive speculation in significant price discovery contracts. The proposed limits in § 150.2, the methodology used for determining limits at the spot, single and all-months combined levels and the determination of distinct levels in physically-delivered and cash-settled contracts all support the Commission's mission to prevent undue or unnecessary burdens on interstate commerce resulting from excess speculation such as the sudden or unreasonable fluctuations or unwarranted changes in commodity prices. Further, by requiring that market participants who avail themselves of the exemptions offered under §150.3 document their exemption eligibility and make such records available on request and through regular reporting to the Commission, the Commission is protecting market participants — hedgers and speculators alike — from another party abusing the exemptions reserved for eligible entities.

The Commission anticipates that market participants engaged in speculative trading will incur costs to monitor their positions vis-a-vis limit levels. The Commission expects that market participants will need to invest additional time and effort to become familiar with new and amended series '04 forms, to gather the necessary information in the required format, and to file reports in the proposed timeframes.

ii. Efficiency, competitiveness, and financial integrity of markets

Position limits help to prevent market manipulation or excessive speculation that may unduly influence prices at the expense of the efficiency and integrity of markets. The expansion of the federal position limits regime to 28 core referenced futures contracts enhances the buffer against excessive speculation historically afforded to the nine legacy contracts exclusively, improving the financial integrity of those markets. Moreover, the proposed limits in § 150.2 promote market competitiveness by preventing a trader from gaining too much market power.

The stringently defined exemptions in § 150.3 and the reporting requirements assigned to those availing themselves of the exemptions provided are the Commission's first line of defense in ensuring that participants transacting in the Commission's jurisdictional markets are doing so in a competitive and efficient environment.

In codifying the Commission's historical practice of temporarily lifting position limit restrictions, the proposed § 150.3(b) financial distress exemption strengthens the benefits of accommodating transfers of positions from financially distressed firms to financially secure firms or facilitating other necessary remediation measures during times of market stress. In addition, it provides market participants with a degree of confidence which contributes to the overall efficiency and financial integrity of markets.

iii. Price discovery

Market manipulation or excessive speculation may result in artificial prices. So, in this sense, position limits might also help to prevent the price discovery function of the underlying commodity markets from being disrupted. On the other hand, imposing position limits raises the concerns that liquidity and price discovery may be diminished, because certain market segments, i.e., speculative traders, are restricted. However, the

Commission has mitigated some of these concerns by proposing various exemptions to positions limits. In addition, applying current DCM-set limits as federal limits means that even though additional contract markets will be brought into the federal position limits regime, the activity of speculative traders, at least initially, will be no less restricted than under the current regime.

iv. Sound risk management

Proposed exemptions for bona fide hedgers help to ensure that market participants with positions that are hedging legitimate commercial needs are properly recognized as hedgers under the Commission's speculative position limits regime. This promotes sound risk management practices. In addition, the Commission has crafted the proposed rules to ensure sufficient market liquidity for bona fide hedgers to the maximum extent practicable, e.g., through the conditional spot month limit exemption.

To the extent that monitoring for position limits requires market participants to create internal risk limits and evaluate position size in relation to the market, position limits may also provide an incentive for market participants to engage in sound risk management practices.

v. Other public interest considerations

The regulations proposed under § 150.5 require that exchange-set limits employ policies that conform to the Commission's general policy both for contracts that are subject to federal limits under § 150.2 and those that are not, thus harmonizing rules for all federal and exchange-set speculative position limits.

B. Paperwork Reduction Act

1. Overview

The PRA[828] imposes certain requirements on Federal agencies in connection with their conducting or sponsoring any collection of information as defined by the PRA. Certain provisions of the regulations proposed herein will result in amendments to approved collection of information requirements within the meaning of the PRA. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number issued by the Office of Management and Budget ("OMB"). Therefore, the Commission is submitting this proposal to OMB for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The information collection requirements proposed in this proposal would amend previously-approved collections associated with OMB control numbers 3038-0009 and 3038-0013.

If adopted, responses to these collections of information would be mandatory. Several of the reporting requirements are mandatory in order to obtain exemptive relief, and are thus mandatory under the PRA to the extent a market participant elects to seek such relief. The Commission will protect proprietary information according to the Freedom of Information Act and 17 CFR part 145, headed "Commission Records and Information." In addition, the Commission emphasizes that section 8(a)(1) of the Act strictly prohibits the Commission, unless specifically authorized by the Act, from making public "data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers."[829] The

[828] 44 U.S.C. 3501 et seq.

[829] 7 U.S.C. 12(a)(1).

Commission also is required to protect certain information contained in a government system of records pursuant to the Privacy Act of 1974.[830]

Under the proposed regulations, market participants with positions in a "referenced contract," as defined in proposed § 150.1, would be subject to the position limit framework established under the proposed revisions to parts 19 and 150. Proposed part 19 prescribes new forms and reporting requirements for persons claiming a conditional spot month limit exemption (proposed Form 504),[831] a pass-through swap exemption (proposed Form 604), [832] or an anticipatory exemption (proposed Form 704).[833] The proposed amendments to part 19 also update and change reporting obligations and required information for Form 204 and Form 304.[834] Proposed part 150 prescribes reporting requirements for DCMs listing a core referenced futures contract[835] and traders who wish to apply for an exemption from DCM- or SEF-established positions limits in non-referenced contracts,[836] as well as recordkeeping requirements for persons who claim exemptions from position limits or are counterparties to a person claiming a pass-through swap offset.[837]

2. <u>Methodology and assumptions</u>

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[830] 5 U.S.C. 552a.

[831] <u>See</u> proposed §§ 19.00(a)(1)(i) and 19.01(a)(1).

[832] <u>See</u> proposed §§ 19.00(a)(1)(ii) and 19.01(a)(2).

[833] The requirement of filing a Form 704 in order to claim an anticipatory exemption is stipulated in proposed § 150.7(a) in addition to its inclusion in proposed amendments to part 19. <u>See</u> proposed §§ 19.00(a)(1)(iv), 19.01(a)(4) and 150.7(a).

[834] <u>See</u> proposed § 19.01(a)(3).

[835] <u>See</u> proposed § 150.2(e)(3)(ii).

[836] <u>See</u> proposed § 150.5(b)(5)(C).

[837] <u>See</u> proposed § 150.3(g).

It is not possible at this time to precisely determine the number of respondents affected by the proposed rules. Many of the regulations that impose PRA burdens are exemptions that a market participant may elect to take advantage of, meaning that without intimate knowledge of the day-to-day business decisions of all its market participants, the Commission could not know which participants, or how many, may elect to obtain such an exemption. Further, the Commission is unsure of how many participants not currently in the market may be required to or may elect to incur the estimated burdens in the future. Finally, many of the regulations proposed herein are applying to participants in swaps markets for the first time, and, as explained supra, the Commission's lack of experience with such markets and with many of the participants therein hinders its ability to determine with precision the number of affected entities.

These limitations notwithstanding, the Commission has made best-effort estimations regarding the likely number of affected entities for the purposes of calculating burdens under the PRA. The Commission used its proprietary data, collected from market participants, to estimate the number of respondents for each of the proposed obligations subject to the PRA. As discussed supra,[838] the Commission analyzed data covering the two year period 2011-2012 to determine how many participants would be over 60, 80, or 100 percent of the proposed limit levels in each of the 28 core referenced futures contracts, were such limit levels to be adopted as proposed.

For purposes of the PRA, Commission staff determined the number of unique traders over the proposed spot-month position limit level for all of the 28 core referenced futures contracts combined. The Commission also determined the number of traders over

[838] See supra discussion of number of traders over the limits.

the non-spot-month position limit level for all of the 28 core referenced futures contracts combined. Staff then added those two figures and rounded it up to the nearest hundred to arrive at an approximation of 400 persons.[839] This base figure was then scaled to estimate, based on the Commission's expertise and experience in the administration of position limits, how many participants may be affected by each specific provision. The analysis reviewed by the Commission does not account for hedging and other exemptions from position limits, which leads the Commission to believe that the approximate number of traders in excess of the limits is a very conservative estimate. The Commission welcomes comment on its estimates, the methodology described above, and its conclusion regarding the conservativeness of its estimates.

The Commission's estimates concerning wage rates are based on 2011 salary information for the securities industry compiled by the Securities Industry and Financial Markets Association ("SIFMA"). The Commission is using a figure of $120 per hour, which is derived from a weighted average of salaries across different professions from the SIFMA Report on Management & Professional Earnings in the Securities Industry 2011, modified to account for an 1800-hour work-year, adjusted to account for the average rate of inflation in 2012. This figure was then multiplied by 1.33 to account for benefits[840] and further by 1.5 to account for overhead and administrative expenses.[841]

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[839] Staff believes that such rounding preserves the reasonability of the estimate without creating a false impression of precision.

[840] The Bureau of Labor Statistics reports that an average of 32.8% of all compensation in the financial services industry is related to benefits. This figure may be obtained on the Bureau of Labor Statistics website, at http://www.bls.gov/news.release/ecec.t06.htm. The Commission rounded this number to 33% to use in its calculations.

[841] Other estimates of this figure have varied dramatically depending on the categorization of the expense and the type of industry classification used (see, e.g., BizStats at http://www.bizstats.com/corporation-industry-financials/finance-insurance-52/securities-commodity-contracts-other-financial-investments-523/commodity-contracts-dealing-and-brokerage-523135/show and Damodaran Online at

The Commission anticipates that compliance with the provisions would require the work of an information technology professional; a compliance manager; an accounting professional; and an associate general counsel. Thus, the wage rate is a weighted national average of salary for professionals with the following titles (and their relative weight); "programmer (average of senior and non-senior)" (15% weight), "senior accountant" (15%) "compliance manager" (30%), and "assistant/associate general counsel" (40%). All monetary estimates have been rounded to the nearest hundred dollars. The Commission welcomes public comment on its assumptions regarding its estimated hourly wage.

3. <u>Information provided by reporting entities/persons and recordkeeping duties</u>

For purposes of assisting the Commission in setting spot-month limits no less frequently than every two years, proposed § 150.2(e)(3)(ii) adds an additional burden cost to information collection 3038-0013 by requiring DCMs to supply the Commission with an estimated spot-month deliverable supply for each core referenced futures contract listed. The estimate must include documentation as to the methodology used in deriving the estimate, including a description and any statistical data employed. The Commission estimates that the submission would require a labor burden of approximately 20 hours per estimate. Thus, a DCM that submits one estimate may incur a burden of 20 hours for a cost, using the estimated hourly wage of $120, of approximately $2,400. DCMs that submit more than one estimate may multiply this per-estimate burden by the number of estimates submitted to obtain an approximate total burden for all submissions, subject to any efficiencies and economies of scale that may result from submitting multiple

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http://*pages.stern.nyu.edu/~adamodar/pc/datasets/uValuedata.xls*) The Commission has chosen to use a figure of 50% for overhead and administrative expenses to attempt to conservatively estimate the average for the industry.

estimates. The Commission welcomes comment regarding the estimated burden on DCMs that will result from proposed § 150.2(e).

Proposed § 150.3(g)(1) adds an additional burden cost to information collection 3038-0013 by requiring any person claiming an exemption from federal position limits under part 150 to keep and maintain books and records concerning all details of their related cash, forward, futures, options and swap positions and transactions to serve as a reasonable basis to demonstrate reduction of risk on each day that the exemption was claimed. These records must be comprehensive, in that they must cover anticipated requirements, production and royalties, contracts for services, cash commodity products and by-products, and cross-commodity hedges. Proposed § 150.3(g)(2) requires any person claiming a pass-through swap offset hedging exemption to obtain a representation that the swap qualifies as a pass-through swap for purposes of a bona fide hedging position. Additionally, proposed § 150.3(g)(3) requires any person representing to another person that a swap qualifies as a pass-through swap for purposes of a bona fide hedging position, to keep and make available to the Commission upon request all relevant books and records supporting such a representation for at least two years following the expiration of the swap.

The Commission estimates that approximately 400 traders will claim an average of 50 exemptions each per year that fall within the scope of the recordkeeping requirements of proposed § 150.3(g). At approximately one hour per exemption claimed to keep and maintain the required books and records, the Commission estimates that industry will incur a total of 20,000 annual labor hours amounting to $2,400,000 in additional labor costs. The Commission requests public comment regarding the burden

associated with the recordkeeping requirements of proposed § 150.3(g) and its estimates thereto.

Proposed § 150.5(b)(5)(iii) adds an additional burden cost to information collection 3038-0013 by requiring traders who wish to avail themselves of any exemption from a DCM or SEF's speculative position limit rules that is allowed for under § 150.5(b)(5)(A)-(B) to submit an application to the DCM or SEF explaining how the exemption would be in accord with sound commercial practices and would allow for a position that could be liquidated in an orderly fashion. As noted supra, the Commission understands that requiring traders to apply for exemptive relief comports with existing DCM practice; thus, the Commission anticipates that the codification of this requirement will have the practical effect of incrementally increasing, rather than creating, the burden of applying for such exemptive relief. The Commission estimates that approximately 400 traders will claim exemptions from DCM or SEF-established speculative position limits each year, with each trader on average making 100 related submissions to the DCM or SEF each year. Each submission is estimated to take 2 hours to complete and file, meaning that these traders would incur a total burden of 80,000 labor hours per year for an industry-wide additional labor cost of $9,600,000. The Commission welcomes all comment regarding the estimated burden on market participants wishing to avail themselves of a DCM or SEF exemption.

Proposed § 19.01(a)(1) adds an additional burden cost to information collection 3038-0009 for persons claiming a conditional spot month limit exemption pursuant to § 150.3(c), by requiring the filing of Form 504 for special commodities so designated by the Commission under § 19.03. A Form 504 filing shows the composition of the cash

position of each commodity underlying a referenced contract that is held or controlled for which the exemption is claimed,[842] including the "as of" date, the quantity of stocks owned of such commodity, the quantity of fixed-price purchase commitments open providing for receipt of such cash commodity, the quantity of fixed-price sale commitments open providing for delivery of such cash commodity, the quantity of unfixed-price purchase commitments open providing for receipt of such cash commodity, and the quantity of unfixed-price sale commitments open providing for delivery of such cash commodity. The Commission estimates that approximately 40 traders will claim a conditional spot month limit 12 times per year, and each corresponding submission will take 15 labor hours to complete and file. Therefore, the Commission estimates that the Form 504 reporting requirement will result in approximately 7,200 total annual labor hours for an additional industry-wide labor cost of $864,000. The Commission requests comment on its estimates regarding new Form 504. In particular, the Commission welcomes comment regarding the number of entities who may partake of the conditional limit in natural gas and would thus be required to file Form 504.

Proposed § 19.01(a)(2) adds an additional burden cost to information collection 3038-0009 by requiring persons claiming a pass-through swap exemption pursuant to § 150.3(a)(1)(i) to file Form 604 showing various data depending on whether the offset is for non-referenced contract swaps or spot-month swaps including, at a minimum, the underlying commodity or commodity reference price, the applicable clearing identifiers,

[842] The Commission proposes that initially only the natural gas commodity derivative contracts would be designated under § 19.03 for Form 504 reporting. As such, the Commission's estimates reflect only the burden for traders in that commodity. The Commission is not able to estimate the expanded cost of any future Commission determination to designate another commodity under § 19.03 as a special commodity for which Form 504 filings would be required. See supra discussion regarding the proposed conditional spot month limit.

the notional quantity, the gross long or short position in terms of futures-equivalents in the core referenced futures contracts, and the gross long or short positions in the referenced contract for the offsetting risk position. The Commission estimates that approximately 200 traders will claim a pass-through swap exemption an average of ten times per year each. At approximately 30 labor hours to complete each corresponding submission for a total burden to traders of 60,000 annual labor hours, compliance with the Form 604 filing requirements industry-wide will impose an additional $7,200,000 in labor costs. The Commission requests comment on its estimates regarding new Form 604. In particular, the Commission welcomes comment regarding the number of entities who may utilize the pass-through swap exemption and the burden incurred to file Form 604.

Proposed § 19.01(a)(3) increases existing burden costs previously approved under information collection 3038-0009 by expanding the number of cash commodities that existing Form 204 covers. Additionally, proposed § 19.01(a)(3) requires additional data to be reported on Form 204 and proposed § 19.02 requires additional data to be reported on existing Form 304 (call cotton). Both forms are required to be filed when a trader accumulates a net long or short commodity derivative position in a core referenced futures contract that exceeds a federal limit, and inform the Commission of the trader's cash positions underlying those commodity derivative contracts for purposes of claiming bona fide hedging exemptions.

The Commission estimates that approximately 400 traders will be required to file Form 204 12 times per year each. At an estimated two labor hours to complete and file each Form 204 report for a total annual burden to industry of 9,600 labor hours, the Form

204 reporting requirement will cost industry $1,200,000 in labor costs. The Commission also estimates that approximately 400 traders will be required to make a Form 304 submission for call cotton 52 times per year each. At one hour to complete each submission (representing a net increase of a half hour from the previous estimate) for a total annual burden to industry of 20,800 labor hours, the Form 304 reporting requirement will impose upon industry $2,500,000 in labor costs. Previously, the Commission estimated the combined annual labor hours for both forms to be 1,350 hours, which amounted to a total labor cost to industry of $68,850 per annum.[843] Therefore, the Commission is increasing its net estimate of labor hours and costs associated with existing Form 204 and Form 304 for collection 3038-0009 by 30,400 hours and $3,700,000.[844] The Commission requests comment with respect to its estimates regarding the increased number of entities and additional information required to file Forms 204 and 304.

Proposed § 19.01(a)(4) adds an additional burden cost to information collection 3038-0009 by requiring traders claiming anticipatory exemptions to file Form 704 for the initial statement pursuant to § 150.7(d), the supplemental statement pursuant to § 150.7(e), and the annual update pursuant to § 150.7(f), as well as Form 204 monthly reporting the remaining unsold, unfilled and other anticipated activity for the Specified Period in Form 704, Section A. The Commission estimates that approximately 200 traders will claim anticipatory exemptions every year an average of 10 times each. At an estimated 20 labor hours to complete and file Form 704 for a total annual burden to

[843] This estimate was based upon an average wage rate of $51 per hour. Adjusted to the hourly wage rate used for purposes of this PRA estimate, the previous total labor cost would have been $202,500.

[844] The Commission notes that the burdens associated with Forms 204 and 304 in collection 3038-0009 represent a fraction of the total burden under that collection.

traders of 40,000 labor hours, the anticipatory exemption filing requirement will cost industry an additional $4,800,000 in labor costs. The Commission requests comment on its estimates regarding new Form 704. In particular, the Commission welcomes comment regarding the number of entities who may utilize the anticipatory hedge exemption and the burden incurred to file Form 704.

4. <u>Comments on information collection</u>

The Commission invites the public and other federal agencies to submit comments on any aspect of the reporting and recordkeeping burdens discussed above. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (1) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (2) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (4) minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology. Comments may be submitted directly to the Office of Information and Regulatory Affairs, by fax at (202) 395–6566 or by e-mail at OIRAsubmissions@omb.eop.gov. Please provide the Commission with a copy of comments submitted so that all comments can be summarized and addressed in the final rule preamble. Refer to the Addresses section of this notice for comment submission instructions to the Commission. A copy of the supporting statements for the collection of information discussed above may be obtained by visiting RegInfo.gov. OMB is required

to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is most assured of being fully considered if received by OMB (and the Commission) within 30 days after the publication of this notice of proposed rulemaking.

C. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA") requires that Federal agencies consider whether the rules they propose will have a significant economic impact on a substantial number of small entities and, if so, provide a regulatory flexibility analysis respecting the impact."[845] A regulatory flexibility analysis or certification typically is required for "any rule for which the agency publishes a general notice of proposed rulemaking pursuant to" the notice-and-comment provisions of the Administrative Procedure Act, 5 U.S.C. 553(b).[846] The requirements related to the proposed amendments fall mainly on registered entities, exchanges, futures commission merchants, swap dealers, clearing members, foreign brokers, and large traders.

The Commission has previously determined that registered DCMs, FCMs, SDs, MSPs, ECPs, SEFs, clearing members, foreign brokers and large traders are not small entities for purposes of the RFA.[847] While the requirements under the proposed rulemaking may impact non-financial end users, the Commission notes that position

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[845] 5 U.S.C. 601 et seq.

[846] 5 U.S.C. 601(2), 603–05.

[847] See Policy Statement and Establishment of Definitions of "Small Entities" for Purposes of the Regulatory Flexibility Act, 47 FR 18618, 18619, Apr. 30, 1982 (DCMs, FCMs, and large traders) ("RFA Small Entities Definitions"); Opting Out of Segregation, 66 FR 20740, 20743, Apr. 25, 2001 (ECPs); Position Limits for Futures and Swaps; Final Rule and Interim Final Rule, 76 FR 71626, 71680, Nov. 18, 2011 (clearing members); Core Principles and Other Requirements for Swap Execution Facilities, 78 FR 33476, 33548, June 4, 2013 (SEFs); A New Regulatory Framework for Clearing Organizations, 66 FR 45604, 45609, Aug. 29, 2001 (DCOs); Registration of Swap Dealers and Major Swap Participants, 77 FR 2613, Jan. 19, 2012, (SDs and MSPs); and Special Calls, 72 FR 50209, Aug. 31, 2007 (foreign brokers).

limits levels and filing requirements associated with bona fide hedging apply only to large traders, while requirements to keep records supporting a transaction's qualification for pass-through swap treatment incurs a marginal burden that is mitigated through overlapping recordkeeping requirements for reportable futures traders (current § 18.05) and reportable swap traders (current § 20.6(b); furthermore, these records are ones that such entities maintain, as they would other documents evidencing material financial relationships, in the ordinary course of their businesses.

Accordingly, the Chairman, on behalf of the Commission, hereby certifies, pursuant to 5 U.S.C 605(b), that the actions proposed to be taken herein would not have a significant economic impact on a substantial number of small entities."

IV. Appendices

Appendix A – Studies relating to position limits reviewed and evaluated by the Commission

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130. Westerhoff, Frank, "Speculative Markets and the Effectiveness of Price Limits," December 1, 2003, Journal of Economic Dynamics and Control.

131. Wray, Randall, "The Commodities Market Bubble: Money Manager Capitalism and the Financialization of Commodities," October 1, 2008, Public Policy Brief.

132. Wright, Brian, "International Grain Reserves and Other Instruments to Address Volatility in Grain Markets," January 1, 2012, The World Bank Research Observer.

List of Subjects

17 CFR Part 1

Agricultural commodity, Agriculture, Brokers, Committees, Commodity futures, Conflicts of interest, Consumer protection, Definitions, Designated contract markets, Directors, Major swap participants, Minimum financial requirements for intermediaries, Reporting and recordkeeping requirements, Swap dealers, Swaps.

17 CFR Parts 15 and 17

Brokers, Commodity futures, Reporting and recordkeeping requirements, Swaps.

17 CFR Part 19

Commodity futures, Cottons, Grains, Reporting and recordkeeping requirements, Swaps.

17 CFR Part 32

Commodity futures, Consumer protection, Fraud, Reporting and recordkeeping requirements.

17 CFR Part 37

Registered entities, Registration application, Reporting and recordkeeping requirements, Swaps, Swap execution facilities.

17 CFR Part 38

Block transaction, Commodity futures, Designated contract markets, Reporting and recordkeeping requirements, Transactions off the centralized market.

17 CFR Part 140

Authority delegations (Government agencies), Conflict of interests, Organizations and functions (Government agencies).

17 CFR Part 150

Bona fide hedging, Commodity futures, Cotton, Grains, Position limits, Referenced Contracts, Swaps.

For the reasons stated in the preamble, the Commodity Futures Trading Commission proposes to amend 17 CFR chapter I as follows:

PART 1 – GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. The authority citation for part 1 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 2a, 5, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6k, 6l, 6m, 6n, 6o, 6p, 6r, 6s, 7, 7a–1, 7a–2, 7b, 7b–3, 8, 9, 10a, 12, 12a, 12c, 13a, 13a–1, 16, 16a, 19, 21, 23, and 24, as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010).

§ 1.3 [Amended]

2. Amend §1.3 by removing and reserving paragraph (z).

§§ 1.47 and 1.48 [Removed and Reserved]

3. Remove and reserve §§1.47 and 1.48.

PART 15 – REPORTS – GENERAL PROVISIONS

4. The authority citation for part 15 continues to read as follows:

Authority: 7 U.S.C. 2, 5, 6a, 6c, 6f, 6g, 6i, 6k, 6m, 6n, 7, 7a, 9, 12a, 19, and 21, as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

5. Amend §15.00 by revising paragraph (p) to read as follows:

<u>§ 15.00 Definitions of terms used in parts 15 to 19, and 21 of this chapter.</u>

* * * * *

(p) <u>Reportable position</u> means:

(1) For reports specified in parts 17 and 18, and § 19.00(a)(2) and (3), of this chapter any open contract position that at the close of the market on any business day equals or exceeds the quantity specified in § 15.03 in either:

(i) Any one futures of any commodity on any one reporting market, excluding futures contracts against which notices of delivery have been stopped by a trader or issued by the clearing organization of a reporting market; or

(ii) Long or short put or call options that exercise into the same future of any commodity, or long or short put or call options for options on physicals that have identical expirations and exercise into the same physical, on any one reporting market.

(2) For the purposes of reports specified in § 19.00(a)(1) of this chapter, any position in commodity derivative contracts, as defined in §150.1 of this chapter, that exceeds a position limit in § 150.2 of this chapter for the particular commodity.

* * * * *

6. Amend §15 .01 by revising paragraph (d) to read as follows:

§ 15.01 Persons required to report.

* * * * *

(d) Persons, as specified in part 19 of this chapter, either:

(1) Who hold or control commodity derivative contracts (as defined in §150.1 of this chapter) that exceed a position limit in §150.2 of this chapter for the commodities enumerated in that section; or

(2) Who are merchants or dealers of cotton holding or controlling positions for future delivery in cotton that equal or exceed the amount set forth in §15.03.

7. Revise § 15.02 to read as follows:

§ 15.02 Reporting forms.

Forms on which to report may be obtained from any office of the Commission or via the Internet (http://www.cftc.gov). Forms to be used for the filing of reports follow, and persons required to file these forms may be determined by referring to the rule listed in the column opposite the form number.

Form No.	Title	Rule
40	Statement of Reporting Trader	18.04
71	Identification of Omnibus Accounts and Sub-accounts	17.01
101	Positions of Special Accounts	17.00
102	Identification of Special Accounts, Volume Threshold Accounts, and Consolidated Accounts	17.01
204	Cash Positions of Hedgers (excluding Cotton)	19.00
304	Cash Positions of Cotton Traders	19.00
504	Cash Positions for Conditional Spot Month Exemptions	19.00
604	Counterparty Data for Pass-Through Swap Exemptions	19.00
704	Statement of Anticipatory Bona Fide Hedge Exemptions	19.00

(Approved by the Office of Management and Budget under control numbers 3038-0007, 3038-0009, and 3038-0103)

PART 17 – REPORTS BY REPORTING MARKETS, FUTURES COMMISSION MERCHANTS, CLEARING MEMBERS, AND FOREIGN BROKERS

8. The authority citation for part 17, as amended November 18, 2013, at 78 FR 69230, effective February 18, 2014, continues to read as follows:

Authority: 7 U.S.C. 2, 6a, 6c, 6d, 6f, 6g, 6i, 6t, 7, 7a, and 12a, as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

9. Amend § 17.00 by revising paragraph (b) to read as follows:

<u>§ 17.00 Information to be furnished by futures commission merchants, clearing members and foreign brokers.</u>

* * * * *

(b) <u>Interest in or control of several accounts.</u> Except as otherwise instructed by the Commission or its designee and as specifically provided in §150.4 of this chapter, if any person holds or has a financial interest in or controls more than one account, all such accounts shall be considered by the futures commission merchant, clearing member or foreign broker as a single account for the purpose of determining special account status and for reporting purposes.

* * * * *

10. Amend §17.03, as amended November 18, 2013, at 78 FR 69232, effective February 18, 2014, by adding paragraph (h) to read as follows:

<u>§ 17.03 Delegation of authority to the Director of the Office of Data and Technology or the Director of the Division of Market Oversight.</u>

* * * * *

(h) Pursuant to §1 7.00(b), and as specifically provided in §150.4 of this chapter, the authority shall be designated to the Director of the Division of Market Oversight to instruct an futures commission merchant, clearing member or foreign broker to consider as a single account for the purpose of determining special account status and for reporting purposes all accounts one person holds or controls, or in which the person has a financial interest.

11. Revise part 19 to read as follows:

PART 19 – REPORTS BY PERSONS HOLDING POSITIONS EXEMPT FROM POSITION LIMITS AND BY MERCHANTS AND DEALERS IN COTTON

Sec.	
19.00	General provisions.
19.01	Reports on stocks and fixed price purchases and sales.
19.02	Reports pertaining to cotton on call purchases and sales.
19.03	Reports pertaining to special commodities.
19.04	Delegation of authority to the Director of the Division of Market Oversight.
19.05 – 19.10	[Reserved]
Appendix	Appendix A to Part 19 – Forms 204, 304, 504, 604, and 704

Authority: 7 U.S.C. 6g(a), 6a, 6c(b), 6i, and 12a(5), as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

<u>§19.00 General provisions.</u>

(a) <u>Who must file series '04 reports</u>. The following persons are required to file series '04 reports:

(1) <u>Persons filing for exemption to speculative position limits.</u> All persons holding or controlling positions in commodity derivative contracts, as defined in §150.1 of this chapter, in excess of any speculative position limit provided under §150.2 of this

chapter and for any part of which a person relies on an exemption to speculative position limits under §150.3 of this chapter as follows:

(i) Conditional spot month limit exemption. A conditional spot month limit exemption under §150.3(c) of this chapter for any commodity specially designated by the Commission under §19.03 for reporting;

(ii) Pass-through swap exemption. A pass-through swap exemption under §150.3(a)(1)(i) of this chapter and as defined in paragraph (2)(ii) of the definition of "bona fide hedging position" in §150.1 of this chapter, reporting separately for:

(A) Non-referenced-contract swap offset. A swap that is not a referenced contract, as that term is defined in §150.1 of this chapter, and which is executed opposite a counterparty for which the swap would qualify as a bona fide hedging position and for which the risk is offset with a referenced contract; and

(B) Spot-month swap offset. A cash-settled swap, regardless of whether it is a referenced contract, executed opposite a counterparty for which the swap would qualify as a bona fide hedging position and for which the risk is offset with a physical-delivery referenced contract in its spot month;

(iii) Other exemption. Any other exemption from speculative position limits under §150.3 of this chapter, including for a bona fide hedging position as defined in §150.1 of this chapter or any exemption granted under § 150.3(b) or (d) of this chapter; or

(iv) Anticipatory exemption. An anticipatory exemption under §150.7 of this chapter.

(2) Persons filing cotton on call reports. Merchants and dealers of cotton holding or controlling positions for futures delivery in cotton that are reportable pursuant to §15.00(p)(1)(i) of this chapter; or

(3) Persons responding to a special call. All persons exceeding speculative position limits under §150.2 of this chapter or all persons holding or controlling positions for future delivery that are reportable pursuant to §15.00(p)(1) of this chapter who have received a special call for series '04 reports from the Commission or its designee. Persons subject to a special call shall file CFTC Form 204, 304, 504, 604 or 704 as instructed in the special call. Filings in response to a special call shall be made within one business day of receipt of the special call unless otherwise specified in the call. For the purposes of this paragraph, the Commission hereby delegates to the Director of the Division of Market Oversight, or to such other person designated by the Director, authority to issue calls for series '04 reports.

(b) Manner of reporting. The manner of reporting the information required in §19.01 is subject to the following:

(1) Excluding certain source commodities, products or byproducts of the cash commodity hedged. If the regular business practice of the reporting person is to exclude certain source commodities, products or byproducts in determining his cash positions for bona fide hedging positions (as defined in §150.1 of this chapter), the same shall be excluded in the report, provided that the amount of the source commodity being excluded is de minimis, impractical to account for, and/or on the opposite side of the market from the market participant's hedging position. Such persons shall furnish to the Commission or its designee upon request detailed information concerning the kind and quantity of

source commodity, product or byproduct so excluded. Provided however, when reporting for the cash commodity of soybeans, soybean oil, or soybean meal, the reporting person shall show the cash positions of soybeans, soybean oil and soybean meal.

(2) Cross hedges. Cash positions that represent a commodity, or products or byproducts of a commodity, that is different from the commodity underlying a commodity derivative contract that is used for hedging, shall be shown both in terms of the equivalent amount of the commodity underlying the commodity derivative contract used for hedging and in terms of the actual cash commodity as provided for on the appropriate series '04 form.

(3) Standards and conversion factors. In computing their cash position, every person shall use such standards and conversion factors that are usual in the particular trade or that otherwise reflect the value-fluctuation-equivalents of the cash position in terms of the commodity underlying the commodity derivative contract used for hedging. Such person shall furnish to the Commission upon request detailed information concerning the basis for and derivation of such conversion factors, including:

(i) The hedge ratio used to convert the actual cash commodity to the equivalent amount of the commodity underlying the commodity derivative contract used for hedging; and

(ii) An explanation of the methodology used for determining the hedge ratio.

§19.01 Reports on stocks and fixed price purchases and sales.

(a) Information required.—(1) Conditional spot month limit exemption. Persons required to file ’04 reports under §19.00(a)(1)(i) shall file CFTC Form 504 showing the

composition of the cash position of each commodity underlying a referenced contract that is held or controlled including:

(i) The as of date;

(ii) The quantity of stocks owned of such commodity that either:

(A) Is in a position to be delivered on the physical-delivery core referenced futures contract; or

(B) Underlies the cash-settled core referenced futures contract;

(iii) The quantity of fixed-price purchase commitments open providing for receipt of such cash commodity in:

(A) The delivery period for the physical-delivery core referenced futures contract; or

(B) The time period for cash-settlement price determination for the cash-settled core referenced futures contract;

(iv) The quantity of unfixed-price sale commitments open providing for delivery of such cash commodity in:

(A) The delivery period for the physical-delivery core referenced futures contract; or

(B) The time period for cash-settlement price determination for the cash-settled core referenced futures contract;

(v) The quantity of unfixed-price purchase commitments open providing for receipt of such cash commodity in:

(A) The delivery period for the physical-delivery core referenced futures contract; or

(B) The time period for cash-settlement price determination for the cash-settled core referenced futures contract; and

(vi) The quantity of fixed-price sale commitments open providing for delivery of such cash commodity in:

(A) The delivery period for the physical-delivery core referenced futures contract; or

(B) The time period for cash-settlement price determination for the cash-settled core referenced futures contract.

(2) Pass-through swap exemption. Persons required to file '04 reports under §19.00(a)(1)(ii) shall file CFTC Form 604:

(i) Non-referenced-contract swap offset. For each swap that is not a referenced contract and which is executed opposite a counterparty for which the transaction would qualify as a bona fide hedging position and for which the risk is offset with a referenced contract, showing:

(A) The underlying commodity or commodity reference price;

(B) The applicable clearing identifiers;

(C) The notional quantity;

(D) The gross long or short position in terms of futures-equivalents in the core referenced futures contract; and

(E) The gross long or short positions in the referenced contract for the offsetting risk position; and

(ii) Spot-month swap offset. For each cash-settled swap executed opposite a counterparty for which the transaction would qualify as a bona fide hedging position and

for which the risk is offset with a physical-delivery referenced contract held into a spot month, showing for such cash-settled swap that is not a referenced contract the information required under paragraph (a)(2)(i) of this section and for such cash-settled swap that is a referenced contract:

(A) The gross long or short position for such cash-settled swap in terms of futures-equivalents in the core referenced futures contract; and

(B) The gross long or short positions in the physical-delivery referenced contract for the offsetting risk position.

(3) Other exemptions. Persons required to file '04 reports under §19.00(a)(1)(iii) shall file CFTC Form 204 reports showing the composition of the cash position of each commodity hedged or underlying a reportable position including:

(i) The as of date, an indication of any enumerated bona fide hedging position exemption(s) claimed, the commodity derivative contract held or controlled, and the equivalent core reference futures contract;

(ii) The quantity of stocks owned of such commodities and their products and byproducts;

(iii) The quantity of fixed-price purchase commitments open in such cash commodities and their products and byproducts;

(iv) The quantity of fixed-price sale commitments open in such cash commodities and their products and byproducts;

(v) The quantity of unfixed-price purchase and sale commitments open in such cash commodities and their products and byproducts, in the case of offsetting unfixed-price cash commodity sales and purchases; and

(vi) For cotton, additional information that includes:

(A) The quantity of equity in cotton held by the Commodity Credit Corporation under the provisions of the Upland Cotton Program of the Agricultural Stabilization and Conservation Service of the U.S. Department of Agriculture;

(B) The quantity of certificated cotton owned; and

(C) The quantity of non-certificated stocks owned.

(4) Anticipatory exemptions. Persons required to file '04 reports under §19.00(a)(1)(iv) shall file:

(i) CFTC Form 704 for the initial statement pursuant to §150.7(d) of this chapter, the supplemental statement pursuant to §150.7(e) of this chapter, and the annual update pursuant to §150.7(f) of this chapter; and

(ii) CFTC Form 204 monthly on the remaining unsold, unfilled and other anticipated activity for the Specified Period that was reported on such person's most recently filed Form 704, Section A pursuant to §150.7(g) of this chapter.

(b) Time and place of filing reports.—(1) General. Except for reports filed in response to special calls made under §19.00(a)(3) or reports required under §19.00(a)(1)(i), (a)(1)(ii)(B), or § 19.01(a)(4)(i), each report shall be made monthly:

(i) As of the close of business on the last Friday of the month, and

(ii) As specified in paragraph (b)(3) of this section, and not later than 9 a.m. Eastern Time on the third business day following the date of the report.

(2) Conditional spot month limit. Persons required to file '04 reports under §19.00(a)(1)(i) shall file each report for special commodities as specified by the Commission under §19.03:

(i) As of the close of business for each day the person exceeds the limit during a spot period up to and through the day the person's position first falls below the position limit; and

(ii) As specified in paragraph (b)(3) of this section, and not later than 9 a.m. Eastern Time on the next business day following the date of the report.

(3) Electronic filing. CFTC '04 reports must be transmitted using the format, coding structure, and electronic data transmission procedures approved in writing by the Commission.

§19.02 Reports pertaining to cotton on call purchases and sales.

(a) Information required. Persons required to file '04 reports under §19.00(a)(2) shall file CFTC Form 304 reports showing the quantity of call cotton bought or sold on which the price has not been fixed, together with the respective futures on which the purchase or sale is based. As used herein, call cotton refers to spot cotton bought or sold, or contracted for purchase or sale at a price to be fixed later based upon a specified future.

(b) Time and place of filing reports. Each report shall be made weekly as of the close of business on Friday and filed using the procedure under §19.01(b)(3), not later than 9 a.m. Eastern Time on the third business day following the date of the report.

§19.03 Reports pertaining to special commodities.

From time to time to facilitate surveillance in certain commodity derivative contracts, the Commission may designate a commodity derivative contract for reporting under §19.00(a)(1)(i) and will publish such determination in the Federal Register and on its web site. Persons holding or controlling positions in such special commodity

derivative contracts must, beginning 30 days after notice is published in the Federal Register, comply with the reporting requirements under §19.00(a)(1)(i) and file Form 504 for conditional spot month limit exemptions.

§19.04 Delegation of authority to the Director of the Division of Market Oversight.

(a) The Commission hereby delegates, until it orders otherwise, to the Director of the Division of Market Oversight or such other employee or employees as the Director may designate from time to time, the authority in §19.01 to provide instructions or to determine the format, coding structure, and electronic data transmission procedures for submitting data records and any other information required under this part.

(b) The Director of the Division of Market Oversight may submit to the Commission for its consideration any matter which has been delegated in this section.

(c) Nothing in this section prohibits the Commission, at its election, from exercising the authority delegated in this section.

§§19.05 – 19.10 [Reserved]

Appendix A to Part 19 – Forms 204, 304, 504, 604, and 704

NOTE: This Appendix includes representations of the proposed reporting forms, which would be submitted in an electronic format published pursuant to the proposed rules, either via the Commission's web portal or via XML-based, secure FTP transmission.

CFTC FORM 204
Statement of Cash Positions of Hedgers

NOTICE: Failure to file a report required by the Commodity Exchange Act ("CEA" or the "Act")[848] and the regulations thereunder,[849] or the filing of a report with the Commodity Futures Trading Commission ("CFTC" or "Commission") that includes a false, misleading or fraudulent statement or omits material facts that are required to be reported therein or are necessary to make the report not misleading, may (a) constitute a violation of section 6(c)(2) of the Act (7 U.S.C. 9), section 9(a)(3) of the Act (7 U.S.C. 13(a)(3)), and/or section 1001 of Title 18, Crimes and Criminal Procedure (18 U.S.C. 1001) and (b) result in punishment by fine or imprisonment, or both.

PRIVACY ACT NOTICE

The Commission's authority for soliciting this information is granted in sections 4a, 4c(b), 4i, 4t and 8a(5) of the CEA and related regulations (see, e.g., 17 CFR 19.00). The information solicited from entities and individuals engaged in activities covered by the CEA is required to be provided to the CFTC, and failure to comply may result in the imposition of criminal or administrative sanctions (*see*, e.g., 7 U.S.C. sections 9 and 13a-1, and/or 18 U.S.C. 1001). The information requested is most commonly used in the Commission's market and trade practice surveillance activities to (a) provide information concerning the size and composition of the commodity derivatives markets, (b) permit the Commission to monitor and enforce speculative position limits and (c) enhance the Commission's trade surveillance data. The requested information may be used by the Commission in the conduct of investigations and litigation and, in limited circumstances, may be made public in accordance with provisions of the CEA and other applicable laws. It may also be disclosed to other government agencies and to contract markets to meet responsibilities assigned to them by law. The information will be maintained in, and any additional disclosures will be made in accordance with, the CFTC System of Records Notices, available on www.cftc.gov.

[848] 7 U.S.C. section 1, et seq.
[849] Unless otherwise noted, the rules and regulations referenced in this notice are found in chapter 1 of title 17 of the Code of Federal Regulations; 17 CFR Chapter 1 et seq.

BACKGROUND & INSTRUCTIONS

17 CFR 19.00(a) requires each person subject to the provisions of this paragraph to report its cash positions to the Commission by filing series '04 reports. 17 CFR 19.00(b) specifies the manner of reporting on Form '04 series. 17 CFR 19.01(a)(3) and (a)(4)(ii) specifies the information required on Form 204. 17 CFR 19.01(b)(1) specifies the frequency (**monthly**), the as of report date (close of business on the last Friday of the month), and the time (9 a.m. Eastern Time on the third business day following the date of the report) for filing the reports. As appropriate, please follow the instructions below to generate and submit the required report or filing. Unless the context requires otherwise, the terms used herein shall have the same meaning as ascribed in parts 15 to 21 of the Commission's regulations.

Complete Form 204 as follows:

General & Identifying Information:	All filers.
Section A:	Complete for stock and fixed-price cash positions
Date	As of date for reported position
BFH Claimed	Applicable § 150.1 Definitions BFH position, paragraph (e.g. – (2) Hedge of a physical commodity and (3)(iv) Hedges by Agents, and (5), if cross-hedged)
CDC or RC	CDC or RC, as defined in § 150.1 - used for hedging
CRFC	Corresponding Core Referenced Futures Contract
Futures Equivalent in CRFC	Futures Equivalent in CRFC selected from § 150.2(d)
Cash commodity hedged	Cash commodity hedged by the CDC positions
Units	Units of measure for cash commodity being hedged
Stock	Stocks per § 19.01(a)(3)(ii)
Purchase commitments	Fixed-price purchases pursuant to § 19.01(a)(3)(iii)
Sale commitments	Fixed-price sales pursuant to § 19.01(a)(3)(iv)
Remaining Anticipated Activity	Remaining Unsold, Unfilled and Other Anticipated Activity for the Specified Period in Form 704, Section A, pursuant to § 150.7(g) and § 19.01(a)(4)(ii)
Section B:	Complete for Unfixed-price cash purchases and sales
Date	As of date for reported position
BFH Claimed	Applicable § 150.1 Definitions BFH position, paragraph (e.g. – (2) Hedge of a physical commodity and (3)(iv) Hedges by Agents, and (5), if cross-hedged)
CDC or RC, and corr. CRFC	CDC or RC, as defined in § 150.1 - used for hedging
Futures Equivalent in CRFC	Futures Equivalent in CRFC selected from § 150.2(d)
Cash commodity hedged	Cash commodity hedged by the CDC positions
Units	Units of measure for cash commodity being hedged
Unfixed-price purchases	Unfixed-price purchases per § 19.01(a)(3)(v)
Unfixed-price sales	Unfixed-price sales per § 19.01(a)(3)(v)
Section C:	Complete for cotton, in addition to the above
Stocks	Report positions separately for equity stocks, certificated stocks and non-certificated stocks per § 19.01(a)(3)(vi).
Signature/Authentication:	All filers.

Submitting Form 204: Once completed, please submit this form to the Commission pursuant to the instructions on [www.cftc.gov] or as otherwise directed by Commission staff. If submission attempts fail, the reporting trader shall contact the Commission at [techsupport@cftc.gov] for further technical support.

Please be advised that pursuant to 5 CFR 1320.5(b)(2)(i), you are not required to respond to this collection of information unless it displays a currently valid OMB control number.

COMMODITY FUTURES TRADING COMMISSION
FORM 204 - STATEMENT OF CASH POSITIONS OF HEDGERS

CFTC CODE NO. [INSERT]	OMB No. XXXX-XXXX

Identifying Information		
Identification Codes		
NFA ID	Legal Entity Identifier (LEI)	Other CFTC Identifier

Name of Non-Natural Person

Name of Natural Person			
First Name	Middle Name	Last Name	Suffix

Contact Information		
Address	Phone Number	Email Address

NOTICE: Failure to file a report required by the Commodity Exchange Act ("CEA" or the "Act") and the regulations thereunder, or the filing of a report with the Commodity Futures Trading Commission ("CFTC" or "Commission") that includes a false, misleading or fraudulent statement or omits material facts that are required to be reported therein or are necessary to make the report not misleading, may (a) constitute a violation of § 6(c)(2) of the Act (7 U.S.C. 9), § 9(a)(3) of the Act (7 U.S.C. 13(a)(3)), and/or § 1001 of Title 18, Crimes and Criminal Procedure (18 U.S.C. 1001) and (b) result in punishment by fine or imprisonment, or both. Please be advised that pursuant to 5 CFR § 1320.5(b)(2)(i), you are not required to respond to this collection of information unless it displays a currently valid OMB control number.

A. Cash positions pursuant to the following paragraphs of § 19.01(a)(3)(i), (ii), (iii), (iv), and (4)(ii).

Date	Bona Fide Hedge Indication (BFHI) – Cite specific BFH definition in § 150.1 or other applicable §	Commodity Derivative Contract (CDC) or Referenced Contract (RC) used for Hedging	Core Referenced Futures Contract (CRFC)	Futures Equivalent in Core Reference Futures Contract (CRFC)	Cash Commodity Hedged	Units for Cash Commodity (Specify Tons, CWT, Lbs., Bu., Bbls., etc.)	Stocks Owned	Fixed-Price Purchases	Fixed-Price Sales	Remaining Unsold, Unfilled and Other Anticipated Activity for the Specified Period in Form 704, Section A

B. Offsetting Unfixed-Price Purchases and Sales pursuant to § 19.01(a)(3)(v).								
Date	Bona Fide Hedge Indication (BFHI) – Cite specific BFH definition in § 150.1 or other applicable §	Commodity Derivative Contract (CDC) or Referenced Contract (RC) used for Hedging	Core Referenced Futures Contract (CRFC)	Futures Equivalent in Core Reference Futures Contract (CRFC)	Cash Commodity Hedged	Units for Cash Commodity (Specify Tons, CWT, Lbs., Bu., Bbls., etc.)	Unfixed-Price Purchases	Unfixed-Price Sales

C. Cotton Stocks owned in Section A above pursuant to § 19.01(a)(3)(vi). Report in hundreds of bales (500-lb. bales).		
Equity Stock ('00 bales)	Certificated Stocks ('00 bales)	Non-certificated Stocks ('00 bales)

Please sign/authenticate the Form 204 prior to submitting.

Signature/ Electronic Authentication:

□ By checking this box and submitting this form (or by clicking “submit,” “send,” or any other analogous transmission command if transmitting electronically), I certify that I am duly authorized by the reporting trader identified below to provide the information and representations submitted on this Form 204, and that the information and representations are true and correct.

Reporting Trader Authorized Representative (Name and Position):

_____ (Name)

_____ (Position)

Submitted on behalf of:

_____ (Reporting Trader Name)

Date of Submission:

_____

Form 204, Example A- A commercial entity has inventory of 10,000,000 barrels of crude oil, no fixed-price sales contracts, and 20,000,000 barrels of crude oil in fixed-price purchase contracts. The commercial entity claims a bona fide hedging exemption for a short position of 30,000 contracts in the NYMEX light sweet crude oil futures contract, equivalent to 30,000,000 barrels of crude oil. The commercial entity has other short speculative positions in the futures contract that, absent the bona fide hedging exemption, would cause it to exceed the speculative position limit.

A. Cash positions pursuant to the following paragraphs of § 19.01 (a) (3) (i), (ii), (iii), (iv), and (4)(ii).										
Date	Bona Fide Hedge Indication (BFHI) – Cite specific BFH definition in § 150.1 or other applicable §	Commodity Derivative Contract (CDC) or Referenced Contract (RC) used for Hedging	Core Referenced Futures Contract (CRFC)	Futures Equivalent in Core Reference Futures Contract (CRFC) - = short	Cash Commodity Hedged	Units for Cash Commodity (Specify Tons, CWT, Lbs., Bu., Bbls., etc.)	Stocks Owned	Fixed-Price Purchases	Fixed-Price Sales	Remaining Unsold, Unfilled and Other Anticipated Activity for the Specified Period in Form 704, Section A
5/6/2013	§150.1 BFH (3)(iii)	CL-NYMEX	CL-NYMEX	-30,000	Crude oil	Bbls	10,000,000	20,000,000	0	0

Form 204, Example B- A commercial entity has filed unfilled anticipated requirements in an initial statement on form 704, Section A, in the amount of 120,000,000 MMBtu of natural gas. The current remaining unfilled anticipated requirements are 70,000,000 MMBtu. The person owns stocks of 20,000,000 MMBtu and has entered into fixed-price purchases of 30,000,000 MMBtu. The combined long cash position is long 50,000,000 MMBtu. The total position being hedged, i.e., the remaining unfilled anticipatory requirements of 70,000,000 MMBtu and the long cash position of 50,000,000 MMBtu, equals a long position of 120,000,000 MMBtu in the cash commodity. The commercial entity reports a futures equivalent short position of 10,000 contracts in the CRFC as a hedge, equivalent to short 100,000,000 MMBtu, which is less than the combined long cash position and the remaining unfilled anticipated requirements. Hence, the cash position is partially hedged.

A. Cash positions pursuant to the following paragraphs of § 19.01 (a) (3) (i), (ii), (iii), (iv), and (4)(ii).										
Date	Bona Fide Hedge Indication (BFHI) – Cite specific BFH definition in § 150.1 or other applicable §	Commodity Derivative Contract (CDC) or Referenced Contract (RC) used for Hedging	Core Referenced Futures Contract (CRFC)	Futures Equivalent in Core Reference Futures Contract (CRFC) - = short	Cash Commodity Hedged	Units for Cash Commodity (Specify Tons, CWT, Lbs., Bu., Bbls., etc.)	Stocks Owned	Fixed-Price Purchases	Fixed-Price Sales	Remaining Unsold, Unfilled and Other Anticipated Activity for the Specified Period in Form 704, Section A
5/6/2013	§150.1 BFH (3)(ii) §150.1 BFH (3)(iii)	HH-NYMEX	NG-NYMEX	-10,000	Natural gas	MMBtu	20,000,000	30,000,000	0	70,000,000

Form 204, Example C- A commercial entity has entered into offsetting unfixed-price purchase and sale contracts in the amount of 25,000,000 MMBtu of natural gas. The hedging position is a futures equivalent long position of 10,000 contracts and a futures equivalent short position of 10,000 contracts.

B. Offsetting Unfixed-Price Purchases and Sales pursuant to § 19.01(a)(3) (v).								
Date	Bona Fide Hedge Indication (BFHI) – Cite specific BFH definition in § 150.1 or other applicable §	Commodity Derivative Contract (CDC) or Referenced Contract (RC) used for Hedging	Core Referenced Futures Contract (CRFC)	Futures Equivalent in Core Reference Futures Contract (CRFC)	Cash Commodity Hedged	Units for Cash Commodity (Specify Tons, CWT, Lbs., Bu., Bbls., etc.)	Unfixed-Price Purchases	Unfixed-Price Sales
5/6/2013	§150.1 BFH (3)(ii)	HH-NYMEX	NG-NYMEX	10,000	Natural Gas	MMBtu	25,000,000	25,000,000
	continuation	HH-NYMEX	NG-NYMEX	-10,000	Natural Gas	MMBtu		

Form 204, Example D– A merchant reportable in cotton futures has the following inventory: no equity stock, 100 bales of certificated stock, and 500 bales of non-certificated stock.

C. Cotton Stocks owned in Section A above pursuant to § 19.01(a)(3)(vi). Report in hundreds of bales (500-lb. bales).		
Equity Stock ('00 bales)	Certificated Stocks ('00 bales)	Non-certificated Stocks ('00 bales)
0	1	5

CFTC FORM 304
Statement of Cash Positions for Unfixed-Price Cotton "On Call"

NOTICE: Failure to file a report required by the Commodity Exchange Act ("CEA" or the "Act") [1] and the regulations thereunder,[2] or the filing of a report with the Commodity Futures Trading Commission ("CFTC" or "Commission") that includes a false, misleading or fraudulent statement or omits material facts that are required to be reported therein or are necessary to make the report not misleading, may (a) constitute a violation of section 6(c)(2) of the Act (7 U.S.C. 9), section 9(a)(3) of the Act (7 U.S.C. 13(a)(3)), and/or section 1001 of Title 18, Crimes and Criminal Procedure (18 USC 1001) and (b) result in punishment by fine or imprisonment, or both.

PRIVACY ACT NOTICE

The Commission's authority for soliciting this information is granted in sections 4i and 8 of the CEA and related regulations (see, e.g., 17 CFR 19.02). The information solicited from entities and individuals engaged in activities covered by the CEA is required to be provided to the CFTC, and failure to comply may result in the imposition of criminal or administrative sanctions (*see*, e.g., 7 U.S.C. 9 and 13a-1, and/or 18 U.S.C. 1001). The information requested is most commonly used in the Commission's market and trade practice surveillance activities to (a) provide information concerning the size and composition of the commodity derivatives markets, (b) permit the Commission to monitor and enforce speculative position limits and (c) enhance the Commission's trade surveillance data. The requested information may be used by the Commission in the conduct of investigations and litigation and, in limited circumstances, may be made public in accordance with provisions of the CEA and other applicable laws. It may also be disclosed to other government agencies and to contract markets to meet responsibilities assigned to them by law. The information will be maintained in, and any additional disclosures will be made in accordance with, the CFTC System of Records Notices, available on www.cftc.gov.

[1] 7 U.S.C. section 1, et seq.
[2] Unless otherwise noted, the rules and regulations referenced in this notice are found in chapter 1 of title 17 of the Code of Federal Regulations; 17 CFR Chapter 1 et seq.

BACKGROUND & INSTRUCTIONS

17 CFR 19.00(a) requires each person subject to the provisions of this paragraph to report its cash positions to the Commission by filing series '04 reports. 17 CFR 19.00(b) specifies the manner of reporting on Form '04 series. 17 CFR 19.02(a) specifies the information required on Form 304. 17 CFR 19.02(b) specifies the frequency (**weekly**), the as of report date (close of business Friday,) and the time (9 a.m. Eastern Time on the third business day following the report date) for filing the reports. As appropriate, please follow the instructions below to generate and submit the required report or filing. Unless the context requires otherwise, the terms used herein shall have the same meaning as ascribed in parts 15 to 21 of the Commission's regulations.

Complete Form 304 as follows:

General & Identifying Information:	All filers.
For each listed stock, report	Delivery month
	Delivery year
	Call purchases
	Call sales
Signature/Authentication:	All filers.

Submitting Form 304: Once completed, please submit this form to the Commission pursuant to the instructions on [www.cftc.gov] or as otherwise directed by Commission staff. If submission attempts fail, the reporting trader shall contact the Commission at [techsupport@cftc.gov] for further technical support.

Please be advised that pursuant to 5 CFR 1320.5(b)(2)(i), you are not required to respond to this collection of information unless it displays a currently valid OMB control number.

COMMODITY FUTURES TRADING COMMISSION FORM 304 - STATEMENT OF CASH POSITIONS FOR UNFIXED-PRICE COTTON "ON-CALL"	CFTC CODE NO. [INSERT]			OMB No. XXXX-XXXX
	Identifying Information			
	Identification Codes			
	NFA ID	Legal Entity Identifier (LEI)		Other CFTC Identifier
	Name of Non-Natural Person			
	Name of Natural Person			
	First Name	Middle Name	Last Name	Suffix
	Contact Information			
	Address	Phone Number	Email Address	

NOTICE: Failure to file a report required by the Commodity Exchange Act ("CEA" or the "Act") and the regulations thereunder, or the filing of a report with the Commodity Futures Trading Commission ("CFTC" or "Commission") that includes a false, misleading or fraudulent statement or omits material facts that are required to be reported therein or are necessary to make the report not misleading, may (a) constitute a violation of § 6(c)(2) of the Act (7 U.S.C. 9), § 9(a)(3) of the Act (7 U.S.C. 13(a)(3)), and/or § 1001 of Title 18, Crimes and Criminal Procedure (18 U.S.C. 1001) and (b) result in punishment by fine or imprisonment, or both. Please be advised that pursuant to 5 CFR § 1320.5(b)(2)(i), you are not required to respond to this collection of information unless it displays a currently valid OMB control number.

Unfixed-price Cotton "on-call" pursuant to § 19.02(a); include under "Call Purchases" stocks on hand for which price has not yet been fixed. Report in hundreds of bales (500-lb. bales).

Delivery Month	Delivery Year	Call Purchases ('00 bales)	Call Sales ('00 bales)

Please sign/authenticate the Form 304 prior to submitting.

Signature/ Electronic Authentication:

□ By checking this box and submitting this form (or by clicking “submit,” “send,” or any other analogous transmission command if transmitting electronically), I certify that I am duly authorized by the reporting trader identified below to provide the information and representations submitted on this Form 304, and that the information and representations are true and correct.

Reporting Trader Authorized Representative (Name and Position):

_____ (Name)

_____ (Position)

Submitted on behalf of:

_____ (Reporting Trader Name)

Date of Submission:

_____

Form 304, Example – July 2013 Call purchases of 200 bales and sales of 1,800 bales; October Call purchases of 6,600 bales and sales of 8,000 bales.

Unfixed-price Cotton "on-call" pursuant to § 19.02(a); include under "Call Purchases" stocks on hand for which price has not yet been fixed. Report in hundreds of bales (500-lb. bales).			
Delivery Month	Delivery Year	Call Purchases ('00 bales)	Call Sales ('00 bales)
July	2013	2	18
October	2013	66	80

CFTC FORM 504

Statement of Cash Positions for Conditional Spot Month Exemptions

NOTICE: Failure to file a report required by the Commodity Exchange Act ("CEA" or the "Act")[1] and the regulations thereunder,[2] or the filing of a report with the Commodity Futures Trading Commission ("CFTC" or "Commission") that includes a false, misleading or fraudulent statement or omits material facts that are required to be reported therein or are necessary to make the report not misleading, may (a) constitute a violation of section 6(c)(2) of the Act (7 U.S.C. 9), section 9(a)(3) of the Act (7 U.S.C. 13(a)(3)), and/or section 1001 of Title 18, Crimes and Criminal Procedure (18 U.S.C. 1001) and (b) result in punishment by fine or imprisonment, or both.

PRIVACY ACT NOTICE

The Commission's authority for soliciting this information is granted in sections 4a, 4c(b), 4i, 4t and 8a(5) of the CEA and related regulations (see, e.g., 17 CFR 19.00). The information solicited from entities and individuals engaged in activities covered by the CEA is required to be provided to the CFTC, and failure to comply may result in the imposition of criminal or administrative sanctions (see, e.g., 7 U.S.C. 9 and 13a-1, and/or 18 U.S.C. 1001). The information requested is most commonly used in the Commission's market and trade practice surveillance activities to (a) provide information concerning the size and composition of the commodity derivatives markets, (b) permit the Commission to monitor and enforce speculative position limits and (c) enhance the Commission's trade surveillance data. The requested information may be used by the Commission in the conduct of investigations and litigation and, in limited circumstances, may be made public in accordance with provisions of the CEA and other applicable laws. It may also be disclosed to other government agencies and to contract markets to meet responsibilities assigned to them by law. The information will be maintained in, and any additional disclosures will be made in accordance with, the CFTC System of Records Notices, available on www.cftc.gov.

[1] 7 U.S.C. section 1, et seq.
[2] Unless otherwise noted, the rules and regulations referenced in this notice are found in chapter 1 of title 17 of the Code of Federal Regulations; 17 CFR Chapter 1 et seq.

BACKGROUND & INSTRUCTIONS

17 CFR 19.00(a) requires each person subject to the provisions of this paragraph to report its cash positions to the Commission by filing series '04 reports. 17 CFR 19.00(b) specifies the manner of reporting on Form '04 series. 17 CFR 19.01 (a) (1) specifies the information required on Form 504. 17 CFR 19.01 (b) (2) specifies the frequency (**each day during the spot month**), the as of report date (close of business for each day during the spot month), and the time (9 a.m. Eastern Time on the next business day) for filing the Form 504 spot month reports. As appropriate, please follow the instructions below to generate and submit the required report or filing. Unless the context requires otherwise, the terms used herein shall have the same meaning as ascribed in parts 15 to 21 of the Commission's regulations.

Complete Form 504 as follows:

General & Identifying Information:	All filers.
Data:	Complete for stock and fixed-price cash positions
Date	As of date for reported position -§ 19.01(a)(1)(i)
CRFC	Core Referenced Futures Contract from § 150.2(d)
Cash commodity	Cash commodity identification
Units	Units of measure for cash commodity
Stocks	Deliverable stored commodity - § 19.01(a)(1)(ii)
Fixed-price Purchase	Fixed-price purchase commitments - § 19.01(a)(1)(iii)
Fixed-price Sale	Fixed-price sale commitments - § 19.01(a)(1)(iv)
Unfixed-price Purchase	Unfixed-price purchase commitments - § 19.01(a)(1)(v)
Unfixed-price Sale	Unfixed-price sale commitments - § 19.01(a)(1)(vi)
Signature/Authentication:	All filers.

Submitting Form 504: Once completed, please submit this form to the Commission pursuant to the instructions on [www.cftc.gov] or as otherwise directed by Commission staff. If submission attempts fail, the reporting trader shall contact the Commission at [techsupport@cftc.gov] for further technical support.

Please be advised that pursuant to 5 CFR 1320.5(b)(2)(i), you are not required to respond to this collection of information unless it displays a currently valid OMB control number.

COMMODITY FUTURES TRADING COMMISSION FORM 504 - STATEMENT OF CASH POSITIONS OF SPOT-MONTH HEDGE EXEMPTIONS	CFTC CODE NO. [INSERT]			OMB No. XXXX-XXXX
	Identifying Information			
	Identification Codes			
	NFA ID	Legal Entity Identifier (LEI)		Other CFTC Identifier
	Name of Non-Natural Person			
	Name of Natural Person			
	First Name	Middle Name	Last Name	Suffix
	Contact Information			
	Address	Phone Number	Email Address	

NOTICE: Failure to file a report required by the Commodity Exchange Act ("CEA" or the "Act") and the regulations thereunder, or the filing of a report with the Commodity Futures Trading Commission ("CFTC" or "Commission") that includes a false, misleading or fraudulent statement or omits material facts that are required to be reported therein or are necessary to make the report not misleading, may (a) constitute a violation of § 6(c)(2) of the Act (7 U.S.C. 9), § 9(a)(3) of the Act (7 U.S.C. 13(a)(3)), and/or § 1001 of Title 18, Crimes and Criminal Procedure (18 U.S.C. 1001) and (b) result in punishment by fine or imprisonment, or both. Please be advised that pursuant to 5 CFR 1320.5(b)(2)(i), you are not required to respond to this collection of information unless it displays a currently valid OMB control number.

Cash positions pursuant to § 19.01(a)(1).

Date	Core Reference Futures Contract (CRFC)	Cash Commodity	Units for Cash Commodity (Specify Tons, CWT, Lbs., Bu., Bbls., etc.)	Deliverable Cash Commodity held in Stock or Storage	Fixed-price Cash Purchase Commitment	Fixed-price Cash Sale Commitment	Unfixed-price Cash Purchase Commitment	Unfixed-price Cash Sale Commitment

Please sign/authenticate the Form 504 prior to submitting.

Signature/ Electronic Authentication:

□ By checking this box and submitting this form (or by clicking “submit,” “send,” or any other analogous transmission command if transmitting electronically), I certify that I am duly authorized by the reporting trader identified below to provide the information and representations submitted on this Form 504, and that the information and representations are true and correct.

Reporting Trader Authorized Representative (Name and Position):

_____ (Name)

_____ (Position)

Submitted on behalf of:

_____ (Reporting Trader Name)

Date of Submission:

_____

Form 504 Example. The spot month for the physical-delivery May 2013 NYMEX Henry Hub Natural Gas (NG) futures contract (the CRFC for natural gas) was from the close of business on April 23 through 5:15 p.m. on the last day of trading, April 26, 2013.[1] A trader held positions in cash-settled natural gas referenced contracts settling on April 25, 2013, that were in excess of the spot month limit (1,000 contracts), but that did not exceed five times the spot month limit (5,000 contracts), on each of April 23, 24, and 25, 2013. That trader did not hold any cash-settled referenced contracts settling on April 26, 2013; however, pursuant to § 19.01(b)(2)(i), a person must also report cash positions through the day the person's position first falls below the position limit. Consistent with claiming the conditional spot month limit exemption, the person held no position in the May 2013 NYMEX NG contract during the spot month. Each line of the report represents each day of this conditional spot month limit exemption.

The person's purchase and sales commitments have the same delivery period as that of the May 2013 NYMEX NG contract.[2] As of the close of business on April 23, 2013, the person held: natural gas inventory of 10,000,000 MMBtus; fixed-price purchase contracts of 5,000,000 MMBtus; fixed price sales contracts of 10,000,000 MMBtu; unfixed-price cash purchase contracts of 5,000,000 MMBtu; and unfixed-price cash sales contracts of 5,000,000 MMBtu. The contract prices for each of the unfixed-price sales contracts and the unfixed-price purchase contracts were to become fixed 20 percent per business day on April 24, 25, 26, 29 and 30, 2013. The trader did not execute any cash transactions during the spot month.

Cash positions pursuant to § 19.01(a)(1).								
Date	Core Reference Futures Contract (CRFC)	Cash Commodity	Units for Cash Commodity (Specify Tons, CWT, Lbs., Bu., Bbls., etc.)	Deliverable Cash Commodity held in Stock or Storage	Fixed-price Cash Purchase Commitment	Fixed-price Cash Sale Commitment	Unfixed-price Cash Purchase Commitment	Unfixed-price Cash Sale Commitment

[1] April 23, 2013, was the last trading day of the expiring NYMEX NG contract and 5:15 p.m. on that last trading day was the latest time permitted to transfer an open position, via an exchange of futures for risk position (EFRP) transaction. The NYMEX NG contract unit of trading is 10,000 MMBtu.

[2] The delivery period for the May 2013 NYMEX NG contract was the month of May 2013, with contract terms requiring natural gas to be delivered at as uniform an hourly and daily rate of flow over the course of the delivery month as is possible. Cash commodity inventory and purchase and sales contract quantities are expressed in one million British thermal units (MMBtu).

Cash positions pursuant to § 19.01(a)(1).								
4/23/2013	NG-NYMEX	Natural Gas in U.S.	MMBtu	10,000,000	5,000,000	10,000,000	5,000,000	5,000,000
4/24/2013	NG -NYMEX	Natural Gas in U.S.	MMBtu	10,000,000	6,000,000	11,000,000	4,000,000	4,000,000
4/25/2013	NG-NYMEX	Natural Gas in U.S.	MMBtu	10,000,000	7,000,000	12,000,000	3,000,000	3,000,000
4/26/2013	NG-NYMEX	Natural Gas in U.S.	MMBtu	10,000,000	8,000,000	13,000,000	2,000,000	2,000,000

CFTC FORM 604

Statement of Pass-Through Swap Exemptions

NOTICE: Failure to file a report required by the Commodity Exchange Act ("CEA" or the "Act")[1] and the regulations thereunder,[2] or the filing of a report with the Commodity Futures Trading Commission ("CFTC" or "Commission") that includes a false, misleading or fraudulent statement or omits material facts that are required to be reported therein or are necessary to make the report not misleading, may (a) constitute a violation of section 6(c)(2) of the Act (7 USC 9), section 9(a)(3) of the Act (7 U.S.C. 13(a)(3)), and/or section 1001 of Title 18, Crimes and Criminal Procedure (18 U.S.C. 1001) and (b) result in punishment by fine or imprisonment, or both.

PRIVACY ACT NOTICE

The Commission's authority for soliciting this information is granted in sections 4a, 4c(b), 4i, 4t and 8a(5) of the CEA and related regulations (*see*, e.g., 17 CFR 19.00). The information solicited from entities and individuals engaged in activities covered by the CEA is required to be provided to the CFTC, and failure to comply may result in the imposition of criminal or administrative sanctions (see, e.g., 7 U.S.C. 9 and 13a-1, and/or 18 U.S.C. 1001). The information requested is most commonly used in the Commission's market and trade practice surveillance activities to (a) provide information concerning the size and composition of the commodity derivatives markets, (b) permit the Commission to monitor and enforce speculative position limits and (c) enhance the Commission's trade surveillance data. The requested information may be used by the Commission in the conduct of investigations and litigation and, in limited circumstances, may be made public in accordance with provisions of the CEA and other applicable laws. It may also be disclosed to other government agencies and to contract markets to meet responsibilities assigned to them by law. The information will be maintained in, and any additional disclosures will be made in accordance with, the CFTC System of Records Notices, available on www.cftc.gov.

[1] 7 U.S.C. section 1, et seq.
[2] Unless otherwise noted, the rules and regulations referenced in this notice are found in chapter 1 of title 17 of the Code of Federal Regulations; 17 CFR Chapter 1 et seq.

BACKGROUND & INSTRUCTIONS

17 CFR 19.00(a) requires each person subject to the provisions of this paragraph to report its cash positions to the Commission by filing series '04 reports. 17 CFR 19.00(b) specifies the manner of reporting on Form '04 series. 17 CFR § 19.01(a)(3) specifies the information required on Form 604. 17 CFR 19.01 (b) (1) specifies the frequency (**monthly**), the as of report date (close of business on the last Friday of the month), and the time (9 a.m. Eastern Time on the third business day following the date of the report) for filing the reports pursuant to § 19.00(a)(1)(ii)(A) for pass-through swaps with non-referenced-contract swap offset. CFR § 19.01(b)(2) specifies the frequency (**each day during the spot month**), the as of report date (close of business for each day during the spot month), and the time (9 a.m. Eastern Time on the next business day) for filing the Form 604 spot-month swap offset reports pursuant to § 19.00(a)(1)(ii)(B) for pass-through swaps with spot-month swap offset. As appropriate, please follow the instructions below to generate and submit the required report or filing. Unless the context requires otherwise, the terms used herein shall have the same meaning as ascribed in parts 15 to 21 of the Commission's regulations.

Complete Form 604 as follows:

General & Identifying Information:	All filers.
Section A:	Complete for Non-referenced contract swap offset
Date	As of date for reported position
Non-referenced contract	Underlying Commodity or Commodity Reference Price that is not a Referenced Contract (RC) - § 19.01(a)(2)(i)(A)
CRFC	Corresponding Core Referenced Futures Contract
Applicable Clearing Identifier	§ 19.01(a)(2)(i)(B)
Commodity Quantity Unit – CQU	Unit of Measurement for Commodity
Notional Quantity	§ 19.01(a)(2)(i)(C) in CQU
Position in FE in CRFC	§ 19.01(a)(2)(i)(D), gross long or short positions
Position in RC for offsetting risk	§ 19.01(a)(2)(i)(E), gross long or short positions
Section B:	Complete for Spot-month swap offset
Date	As of date for reported position
Non-referenced contract	Underlying Commodity or Commodity Reference Price that is not a Referenced Contract (RC) - § 19.01(a)(2)(i)(A)
Applicable Clearing Identifier	§ 19.01(a)(2)(i)(B)
Commodity Quantity Unit – CQU	Unit of Measurement for Commodity
Notional Quantity	§ 19.01(a)(2)(i)(C)
Position in FE for cash-settled swaps	§ 19.01(a)(2)(ii)(A), gross long or short positions
Position in p-d RC for offsetting risk	§ 19.01(a)(2)(ii)(B), gross long or short positions in physical-delivery (p-d) referenced contracts (RC)
Signature/Authentication:	All filers.

Submitting Form 604: Once completed, please submit this form to the Commission pursuant to the instructions on [www.cftc.gov] or as otherwise directed by Commission staff. If submission attempts fail, the reporting trader shall contact the Commission at [techsupport@cftc.gov] for further technical support.

Please be advised that pursuant to 5 CFR 1320.5(b)(2)(i), you are not required to respond to this collection of information unless it displays a currently valid OMB control number.

COMMODITY FUTURES TRADING COMMISSION FORM 604 - STATEMENT OF PASS-THROUGH SWAP EXEMPTIONS	CFTC CODE NO. [INSERT]			OMB No. XXXX-XXXX
	Identifying Information			
	Identification Codes			
	NFA ID	Legal Entity Identifier (LEI)	Other CFTC Identifier	
	Name of Non-Natural Person			
	Name of Natural Person			
	First Name	Middle Name	Last Name	Suffix
	Contact Information			
	Address	Phone Number	Email Address	

NOTICE: Failure to file a report required by the Commodity Exchange Act ("CEA" or the "Act") and the regulations thereunder, or the filing of a report with the Commodity Futures Trading Commission ("CFTC" or "Commission") that includes a false, misleading or fraudulent statement or omits material facts that are required to be reported therein or are necessary to make the report not misleading, may (a) constitute a violation of § 6(c)(2) of the Act (7 U.S.C. 9), § 9(a)(3) of the Act (7 U.S.C. 13(a)(3)), and/or § 1001 of Title 18, Crimes and Criminal Procedure (18 U.S.C. 1001) and (b) result in punishment by fine or imprisonment, or both. Please be advised that pursuant to 5 CFR § 1320.5(b)(2)(i), you are not required to respond to this collection of information unless it displays a currently valid OMB control number.

A. Non-referenced contract swap offset pursuant to § 19.01(a)(2)(i), reported and submitted **monthly** pursuant to § 19.01(b)(1)

Date	Underlying Commodity or Commodity Reference Price that is not a Referenced Contract (RC)	Core Referenced Futures contract (CRFC)	Applicable Clearing Identifier	Commodity Quantity Units of Measurement (Specify Tons, Lbs., Bu., Bbls., etc.)	Notional Quantity in CQU	Gross Long Position in Futures Equivalent in the CRFC	Gross Short Position in Futures Equivalent in the CFRC	Gross Long Position in the RC for the Offsetting Risk Position in CQU	Gross Short Position in the RC for the Offsetting Risk Position in CQU

B. Spot-month swap offset pursuant to § 19.01(a)(2)(ii), reported and submitted **daily** pursuant to § 19.01(b)(2) for non-referenced and referenced cash-settled swaps									
Date	Non-referenced or referenced contract for cash-settled swap offsetting BFH exemption of counterparty	Core Referenced Futures contract (CRFC)	Applicable Clearing identifier	Commodity Quantity Units of Measurement (Specify Tons, Lbs., Bu., Bbls., etc.) - CQU	Notional Quantity in CQU	Gross Long Position for Cash-settled Swap in Futures Equivalent in the CRFC	Gross Short Position for Cash-settled Swap in Futures Equivalent in the CFRC	Gross Long Position in the Physical-delivery RC for the Offsetting Risk Position in CQU	Gross Short Position in the Physical-delivery RC for the Offsetting Risk Position in CQU

Please sign/authenticate the Form 604 prior to submitting.

Signature/ Electronic Authentication:

□ By checking this box and submitting this form (or by clicking “submit,” “send,” or any other analogous transmission command if transmitting electronically), I certify that I am duly authorized by the reporting trader identified below to provide the information and representations submitted on this Form 604, and that the information and representations are true and correct.

Reporting Trader Authorized Representative (Name and Position):

_____ (Name)

_____ (Position)

Submitted on behalf of:

_____ (Reporting Trader Name)

Date of Submission:

_____

Form 604, Example A. A person offsets a long position in a cash-settled milo swap with a notional size of 5,000,000 bushels, using the CBOT Corn futures contract, as a cross-commodity hedge. The milo swap was a bona fide hedging position for the swap counterparty, and was not cleared. For illustrative purposes, the hedge ratio is assumed to be one-to-one between milo and corn.

A. Non-referenced contract swap offset pursuant to § 19.01(a)(2)(i), reported and submitted **monthly** pursuant to § 19.01(b)(1)									
Date	Underlying Commodity or Commodity Reference Price that is not a Referenced Contract (RC)	Core Referenced Futures contract (CRFC)	Applicable Clearing Identifier	Commodity Quantity Units of Measurement (Specify Tons, Lbs., Bu., Bbls., etc.)	Notional Quantity in CQU	Gross Long Position in Futures Equivalent in the CRFC	Gross Short Position in Futures Equivalent in the CFRC	Gross Long Position in the RC for the Offsetting Risk Position in CQU	Gross Short Position in the RC for the Offsetting Risk Position in CQU
6/28/2013	Milo	C-CBOT	NA	Bu	5,000,000	1,000	0	0	5,000,000

Form 604, Example B. A person offsets a cash-settled corn swap with a notional size of 5,000,000 bushels, using the CBOT Corn futures contract during the spot month. An exemption for swap offsets is not permitted in the physical-delivery CBOT Corn futures contract in the last five days of trading. For the May 2013 CBOT Corn futures contract, the last day of trading is May 14 (CBOT rules specify the last trading day as the business day preceding the fifteenth calendar day of the contract month). Hence, the spot month swap offset exemption is not available in the May 2013 CBOT Corn futures contract as of the close of business on May 7, 2013. At that time, the trader must comply with the 600 contract spot month limit, equivalent to 3,000,000 bushels of corn, absent another exemption. Each line represents each day's report for this swap offset position. The spot month for the CBOT Corn futures contract begins at the close of trading two business days prior to the first trading day of the delivery month; hence, April 29, 2013, was the start of the spot month for the May 2013 CBOT Corn futures contract. The corn swap was a bona fide hedging position for the swap counterparty, and was not cleared.

B. Spot-month swap offset pursuant to § 19.01(a)(2)(ii), reported and submitted **daily** pursuant to § 19.01(b)(2) for non-referenced and referenced cash-settled swaps									
Date	Non-referenced or referenced contract for cash-settled swap offsetting BFH exemption of counterparty	Core Referenced Futures contract (CRFC)	Applicable Clearing Identifier	Commodity Quantity Units of Measurement (Specify Tons, Lbs., Bu., Bbls., etc.) - CQU	Notional Quantity in CQU	Gross Long Position for Cash-settled Swap in Futures Equivalent in the CRFC	Gross Short Position for Cash-settled Swap in Futures Equivalent in the CFRC	Gross Long Position in the Physical-delivery RC for the Offsetting Risk Position in CQU	Gross Short Position in the Physical-delivery RC for the Offsetting Risk Position in CQU
4/29/2013	Corn swap	C-CBOT	NA	Bu	5,000,000	1,000	0	0	5,000,000
5/30/2013	Corn swap	C-CBOT	NA	Bu	5,000,000	1,000	0	0	5,000,000
5/01/2013	Corn swap	C-CBOT	NA	Bu	5,000,000	1,000	0	0	5,000,000
5/02/2013	Corn swap	C-CBOT	NA	Bu	5,000,000	1,000	0	0	5,000,000
5/03/2013	Corn swap	C-CBOT	NA	Bu	5,000,000	1,000	0	0	5,000,000
5/06/2013	Corn swap	C-CBOT	NA	Bu	5,000,000	1,000	0	0	5,000,000
5/07/2013	Corn swap	C-CBOT	NA	Bushels-Bu	5,000,000	1,000	0	0	3,000,000

CFTC FORM 704
Statement of Anticipatory Bona Fide Hedge Exemptions

NOTICE: Failure to file a report required by the Commodity Exchange Act ("CEA" or the "Act")[1] and the regulations thereunder,[2] or the filing of a report with the Commodity Futures Trading Commission ("CFTC" or "Commission") that includes a false, misleading or fraudulent statement or omits material facts that are required to be reported therein or are necessary to make the report not misleading, may (a) constitute a violation of section 6(c)(2) of the Act (7 USC 9), section 9(a)(3) of the Act (7 U.S.C. 13(a)(3)), and/or section 1001 of Title 18, Crimes and Criminal Procedure (18 U.S.C. 1001) and (b) result in punishment by fine or imprisonment, or both.

PRIVACY ACT NOTICE

The Commission's authority for soliciting this information is granted in sections 4a, 4c(b), 4i, 4t and 8a(5) of the CEA and related regulations (see, e.g., 17 CFR 19.00). The information solicited from entities and individuals engaged in activities covered by the CEA is required to be provided to the CFTC, and failure to comply may result in the imposition of criminal or administrative sanctions (*see*, e.g., 7 U.S.C. 9 and 13a-1, and/or 18 U.S.C. 1001). The information requested is most commonly used in the Commission's market and trade practice surveillance activities to (a) provide information concerning the size and composition of the commodity derivatives markets, (b) permit the Commission to monitor and enforce speculative position limits and (c) enhance the Commission's trade surveillance data. The requested information may be used by the Commission in the conduct of investigations and litigation and, in limited circumstances, may be made public in accordance with provisions of the CEA and other applicable laws. It may also be disclosed to other government agencies and to contract markets to meet responsibilities assigned to them by law. The information will be maintained in, and any additional disclosures will be made in accordance with, the CFTC System of Records Notices, available on www.cftc.gov.

[1] 7 U.S.C. section 1, et seq.
[2] Unless otherwise noted, the rules and regulations referenced in this notice are found in chapter 1 of title 17 of the Code of Federal Regulations; 17 CFR Chapter 1 et seq.

BACKGROUND & INSTRUCTIONS

17 CFR 19.00(a) requires each person subject to the provisions of this paragraph to report its cash positions to the Commission by filing series '04 reports. 17 CFR 19.00(b) specifies the manner of reporting on Form '04 series. 17 CFR 19.01(a)(4) specifies the information required on Form 704. 17 CFR § 150.7 specifies that a person shall file Form 704 with the Commission at least ten days in advance of the date such exemption is needed. As appropriate, please follow the instructions below to generate and submit the required report or filing. Unless the context requires otherwise, the terms used herein shall have the same meaning as ascribed in parts 15 to 21 of the Commission's regulations.

Complete Form 704 as follows:

General & Identifying Information:	All filers.
Section A:	Initial anticipatory, § 150.7 (d), and supplemental, § 150.7 (e) for change from initial anticipatory
Anticipated Activity	§ 150.1 BFH definition (3)(iii), (4)(i),(4)(iii), (4)(iv), or (5)
Cash Commodity	§ 150.7 (d)(1)(i)
Units	Units of measure for cash commodity being hedged
CRFC	Corresponding Core Referenced Futures Contract
Cash commodity and CRFC	§ 150.7 (d)(1)(iii) and § 150.2 (d) Table of CRFCs
Annual Activity last three years	§ 150.7 (d)(1)(iv)
Specific Time Period Claimed	§ 150.7 (d)(1)(v)
Anticipated for Specified Time	§ 150.7 (d)(1)(vi)
Fixed Price Forward Activity	§ 150.7 (d)(1)(vii)
Unsold, Unfilled, Anticipated	§ 150.7 (d)(1)(viii)
Maximum expected Hedge	§ 150.7 (d)(1)(ix)
Section B:	Monthly update of actuals and estimated utilization of the anticipatory hedge in the initial statement
Anticipated Activity	§ 150.1 BFH definition (3)(iii), (4)(i),(4)(iii), (4)(iv), or (5)
Cash Commodity	§ 150.7 (f)(1)(i)
Units	Units of measure for cash commodity being hedged
Cash commodity and CRFC	§ 150.7 (f)(1)(iii)
Activity for the reporting month	§ 150.7 (f)(1)(iv)
Cumulative activity	§ 150.7 (f)(1)(v)
Estimated remaining activity	§ 150.7 ff)(1)(vi)
Fixed Price forward for Month	§ 150.7 (f)(1)(vii)
Remaining anticipated	§ 150.7 (f)(1)(viii)
Remaining maximum Hedge	§ 150.7 (f)(1)(ix)
Signature/Authentication:	All filers.

Submitting Form 704: Once completed, please submit this form to the Commission pursuant to the instructions on [www.cftc.gov] or as otherwise directed by Commission staff. If submission attempts fail, the reporting trader shall contact the Commission at [techsupport@cftc.gov] for further technical support.

Please be advised that pursuant to 5 CFR 1320.5(b)(2)(i), you are not required to respond to this collection of information unless it displays a currently valid OMB control number.

COMMODITY FUTURES TRADING COMMISSION FORM 704 - STATEMENT OF ANTICIPATORY BONA FIDE HEDGE EXEMPTIONS	CFTC CODE NO. [INSERT]			OMB No. XXXX-XXXX
	Identifying Information			
	Identification Codes			
	NFA ID	Legal Entity Identifier (LEI)		Other CFTC Identifier
	Name of Non-Natural Person			
	Name of Natural Person			
	First Name	Middle Name	Last Name	Suffix
	Contact Information			
	Address	Phone Number	Email Address	

NOTICE: Failure to file a report required by the Commodity Exchange Act ("CEA" or the "Act") and the regulations thereunder, or the filing of a report with the Commodity Futures Trading Commission ("CFTC" or "Commission") that includes a false, misleading or fraudulent statement or omits material facts that are required to be reported therein or are necessary to make the report not misleading, may (a) constitute a violation of § 6(c)(2) of the Act (7 U.S.C. 9), § 9(a)(3) of the Act (7 U.S.C. 13(a)(3)), and/or § 1001 of Title 18, Crimes and Criminal Procedure (18 U.S.C. 1001) and (b) result in punishment by fine or imprisonment, or both. Please be advised that pursuant to 5 CFR § 1320.5(b)(2)(i), you are not required to respond to this collection of information unless it displays a currently valid OMB control number.

A. Initial Anticipatory Exemption Statement and Supplemental Statement for Change in Anticipatory Activity pursuant to § 150.7 (d) and (e)

Anticipated Activity (Production, Requirements, Royalty Receipts, Service Contract Payments or Receipt)	Type and Name of Cash Commodity Underlying Anticipated Activity	Units for Cash Commodity (Specify Tons, CWT, Lbs., Bu., Bbls., etc.)	Core Referenced Futures contract (CRFC)	Cash Commodity Same as (S) or Cross-hedged (C-H) with Core Reference Futures Contract (CRFC)	Annual Production, Requirements, Royalty Receipts, Service Contract Payments or Receipts for Preceding Three Years	Specified Time Period for which Anticipatory Hedge Exemption is Claimed	Anticipated Activity for Such specified Time Period in Futures Equivalent	Fixed-Price Forward sales, Inventory, and Fixed Price Forward Purchases	Unsold, Unfilled and Anticipated Activity	Maximum Number of Long or Short Positions in RC expected to be used to offset Anticipated Activity

B. Annual Update Statement on the Utilization of Anticipatory Exemption pursuant to § 150.7 (f)

Anticipated Activity (Production, Requirements, Royalty Receipts, Service Contract Payments or Receipt)	Type and Name of Cash Commodity Underlying Anticipated Activity	Units for Cash Commodity (Specify Tons, CWT, Lbs., Bu., Bbls., etc.)	Core Referenced Futures contract (CRFC)	Cash Commodity Same as (S) or Cross-hedged (C-H) with Core Reference Futures Contract (CRFC)	Actual Production, Requirements, Royalty Receipts, Service Contract Payments or Receipts for the Month	Cumulative Actual Production, Requirements, Royalty Receipts, Service Contract Payments or Receipts for All Months since the Initial Statement	Estimated Anticipated Activity for the Remainder of Such specified Time Period in Futures Equivalent	Fixed-Price Forward sales, Inventory, and Fixed Price Forward Purchases for the Month	Remaining Unsold, Unfilled and Other Anticipated Activity for the Specified Period	Maximum Number of Long or Short Positions in RC expected to be used to offset Anticipated Activity for the Remainder of the Specified Period

Please sign/authenticate the Form 704 prior to submitting.

Signature/ Electronic Authentication:

□ By checking this box and submitting this form (or by clicking “submit,” “send,” or any other analogous transmission command if transmitting electronically), I certify that I am duly authorized by the reporting trader identified below to provide the information and representations submitted on this Form 704, and that the information and representations are true and correct.

Reporting Trader Authorized Representative (Name and Position):

_____ (Name)

_____ (Position)

Submitted on behalf of:

_____ (Reporting Trader Name)

Date of Submission:

_____

Form 704, Example A – A producer files an initial anticipatory exemption for anticipated production of crude oil for the next three years. The producer had production over the prior three calendar years (15 million, 18 million, and 20 million barrels) and is highly certain of anticipated production for the next 3 calendar years of 20 million barrels per year. The producer has no forward sales; hence, the full 60 million barrels of anticipated production (20 million barrels of anticipated production per year for three years) is unsold anticipated production. The unit of trading for the NYMEX Light Sweet Crude Oil futures contract (CL) is 1,000 barrels. The maximum hedge would be a short position of 60,000 contracts in the NYMEX CL contract.

A. Initial Anticipatory Exemption Statement and Supplemental Statement for Change in Anticipatory Activity pursuant to § 150.7 (d) and (e)									
Anticipated Activity (Production, Requirements, Royalty Receipts, Service Contract Payments or Receipt)	Type and Name of Cash Commodity Underlying Anticipated Activity	Units for Cash Commodity (Specify Tons, CWT, Lbs., Bu., Bbls., etc.)	Cash Commodity Same as (S) or Cross-hedged (C-H) with Core Reference Futures Contract (CRFC)	Annual Production, Requirements, Royalty Receipts, Service Contract Payments or Receipts for Preceding Three Years	Specified Time Period for which Anticipatory Hedge Exemption is Claimed	Anticipated Activity for Such specified Time Period in Futures Equivalent	Fixed-Price Forward sales, Inventory, and Fixed Price Forward Purchases	Unsold, Unfilled and Anticipated Activity	Maximum Number of Long or Short Positions in RC expected to be used to offset Anticipated Activity
Production	Crude oil	(m='000,000) Bbls	CL - NYMEX	2010-15m 2011-18m 2012-20m	3 years	60,000	0	60,000	-60,000

Form 704, Example B. After one year, the producer in Example A files an annual update. Actual production for the prior year was 20 million barrels, as forecasted. The producer remains highly certain of 40 million barrels of production (20 million barrels of crude oil for each of the next two years). The producer has sold forward 10 million barrels. Hence, remaining unsold anticipated production is 30 million barrels. The maximum hedge would be a short position of 30,000 contracts in the NYMEX CL contract.

B. Statement of Annual Update on the Utilization of Anticipatory Exemption pursuant to § 150.7 (f)									
Anticipated Activity (Production, Requirements, Royalty Receipts, Service Contract Payments or Receipt)	Type and Name of Cash Commodity Underlying Anticipated Activity	Units for Cash Commodity (Specify Tons, CWT, Lbs., Bu., Bbls., etc.)	Cash Commodity Same as (S) or Cross-hedged (C-H) with Core Reference Futures Contract (CRFC)	Actual Production, Requirements, Royalty Receipts, Service Contract Payments or Receipts for the Month	Cumulative Actual Production, Requirements, Royalty Receipts, Service Contract Payments or Receipts for All Months since the Initial Statement	Estimated Anticipated Activity for the Remainder of Such specified Time Period in Futures Equivalent	Fixed-Price Forward sales, Inventory, and Fixed Price Forward Purchases for the Year	Remaining Unsold, Unfilled and Anticipated Activity for the Specified Period	Maximum Number of Long or Short Positions in RC expected to be used to offset Anticipated Activity for the Remainder of the Specified Period
Production	Crude oil	(m='000,000) Bbls	CL - NYMEX	2013-20m	1 year	40,000	-10,000	30,000	-30,000

PART 32 – REGULATION OF COMMODITY OPTION TRANSACTIONS

12. The authority citation for part 32 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 6c, and 12a, unless otherwise noted.

13. Amend §32.3 by revising paragraph (c)(2) to read as follows:

§32.3 Trade options.

* * * * *

(c) * * *

(2) Part 150 (Position Limits) of this chapter;

* * * * *

PART 37 – SWAP EXECUTION FACILITIES

14. The authority citation for part 37 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 5, 6, 6c, 7, 7a–2, 7b–3, and 12a, as amended by Titles VII and VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376

15. Revise §37.601 to read as follows:

§37.601 Additional sources for compliance.

A swap execution facility that is a trading facility must meet the requirements of part 150 of this chapter, as applicable.

16. In Appendix B to part 37, under the heading Core Principle 6 of Section 5H of the Act, revise the introductory text of paragraph (B) and paragraph (B)(2)(a) to read as follows:

Appendix B to Part 37 – Guidance on, and Acceptable Practices in, Compliance with Core Principles

* * * * *

CORE PRINCIPLE 6 OF SECTION 5H OF THE ACT – POSITION LIMITS OR ACCOUNTABILITY

* * * * *

(B) Position limits. For any contract that is subject to a position limitation established by the Commission pursuant to section 4a(a) of the Act, the swap execution facility that is a trading facility shall:

* * * * *

(2) * * *

(a) Guidance. A swap execution facility that is a trading facility must meet the requirements of part 150 of this chapter, as applicable. A swap execution facility that is not a trading facility should consider part 150 of this chapter as guidance.

* * * * *

PART 38 – DESIGNATED CONTRACT MARKETS

17. The authority citation for part 38 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 6, 6a, 6c, 6d, 6e, 6f, 6g, 6i, 6j, 6k, 6l, 6m, 6n, 7, 7a-2, 7b, 7b-1, 7b-3, 8, 9, 15, and 21, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376.

18. Revise §38.301 to read as follows:

§38.301 Position limitations and accountability.

A designated contract market must meet the requirements of part 150 of this chapter, as applicable.

PART 140 – ORGANIZATION, FUNCTIONS, AND PROCEDURES OF THE COMMISSION

19. The authority citation for part 140 continues to read as follows:

Authority: 7 U.S.C. 2(a)(12), 13(c), 13(d), 13(e), and 16(b).

§ 140.97 [Removed and Reserved]

20. Remove and reserve §140.97.

PART 150 – LIMITS ON POSITIONS

21. The authority citation for part 150 is revised to read as follows:

Authority: 7 U.S.C. 1a, 2, 5, 6, 6a, 6c, 6f, 6g, 6t, 12a, 19, as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010).

22. Revise §150.1 to read as follows:

§150.1 Definitions.

As used in this part—

Basis contract means a commodity derivative contract that is cash-settled based on the difference in:

(1) The price, directly or indirectly, of:

(i) A particular core referenced futures contract; or

(ii) 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:

(i) 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

(ii) A commodity that is listed in Appendix B of this part as substantially the same as a commodity underlying the same core referenced futures contract.

Bona fide hedging position means any position whose purpose is to offset price risks incidental to commercial cash, spot, or forward operations, and such position is established and liquidated in an orderly manner in accordance with sound commercial practices, provided that:

(1) Hedges of an excluded commodity. For a position in commodity derivative contracts in an excluded commodity, as that term is defined in section 1a(19) of the Act:

(i) Such position is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and

(ii)(A) Is enumerated in paragraph (3), (4) or (5) of this definition; or

(B) Such position is recognized as a bona fide hedging position by the designated contract market or swap execution facility that is a trading facility, pursuant to such market's rules submitted to the Commission, which rules may include risk management exemptions consistent with Appendix A of this part; and

(2) Hedges of a physical commodity. For a position in commodity derivative contracts in a physical commodity:

(i) Such position:

(A) Represents a substitute for transactions made or to be made, or positions taken or to be taken, at a later time in a physical marketing channel;

(B) Is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise;

(C) Arises from the potential change in the value of—

(1) Assets which a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising;

(2) Liabilities which a person owes or anticipates incurring; or

(3) Services that a person provides, purchases, or anticipates providing or purchasing; and

(D) Is enumerated in paragraph (3), (4) or (5) of this definition; or

(ii)(A) Pass-through swap offsets. Such position reduces risks attendant to a position resulting from a swap in the same physical commodity that was executed opposite a counterparty for which the position at the time of the transaction would qualify as a bona fide hedging position pursuant to paragraph (2)(i) of this definition (a pass-through swap counterparty), 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 the time period for the spot month in such physical-delivery commodity derivative contract; and

(B) Pass-through swaps. Such swap position was executed opposite a pass-through swap counterparty and to the extent such swap position has been offset pursuant to paragraph (2)(ii)(A) of this definition.

(3) Enumerated hedging positions. A bona fide hedging position includes any of the following specific positions:

(i) Hedges of inventory and cash commodity purchase contracts. Short positions in commodity derivative contracts that do not exceed in quantity ownership or fixed-price purchase contracts in the contract's underlying cash commodity by the same person.

(ii) Hedges of cash commodity sales contracts. Long positions in commodity derivative contracts that do not exceed in quantity the fixed-price sales contracts in the contract's underlying cash commodity by the same person and the quantity equivalent of fixed-price sales contracts of the cash products and by-products of such commodity by the same person.

(iii) Hedges of unfilled anticipated requirements. Provided that such positions in a physical-delivery commodity derivative contract, during the lesser of the last five days of trading or the time period for the spot month in such physical-delivery contract, do not exceed the person's unfilled anticipated requirements of the same cash commodity for that month and for the next succeeding month:

(A) Long positions in commodity derivative contracts that do not exceed in quantity unfilled anticipated requirements of the same cash commodity, and that do not exceed twelve months for an agricultural commodity, for processing, manufacturing, or use by the same person; and

(B) Long positions in commodity derivative contracts that do not exceed in quantity unfilled anticipated requirements of the same cash commodity for resale by a utility that is required or encouraged to hedge by its public utility commission on behalf of its customers' anticipated use.

(iv) Hedges by agents. Long or short positions in commodity derivative contracts by an agent who does not own or has not contracted to sell or purchase the offsetting cash commodity at a fixed price, provided that the agent is responsible for merchandising the cash positions that are being offset in commodity derivative contracts and the agent has a

contractual arrangement with the person who owns the commodity or holds the cash market commitment being offset.

(4) Other enumerated hedging positions. A bona fide hedging position also includes the following specific positions, provided that no such position is maintained in any physical-delivery commodity derivative contract during the lesser of the last five days of trading or the time period for the spot month in such physical-delivery contract:

(i) Hedges of unsold anticipated production. Short positions in commodity derivative contracts that do not exceed in quantity unsold anticipated production of the same commodity, and that do not exceed twelve months of production for an agricultural commodity, by the same person.

(ii) Hedges of offsetting unfixed-price cash commodity sales and purchases. Short and long positions in commodity derivative contracts that do not exceed in quantity that amount of the same cash commodity that has been bought and sold by the same person at unfixed prices:

(A) Basis different delivery months in the same commodity derivative contract; or

(B) Basis different commodity derivative contracts in the same commodity, regardless of whether the commodity derivative contracts are in the same calendar month.

(iii) Hedges of anticipated royalties. Short positions in commodity derivative contracts offset by the anticipated change in value of mineral royalty rights that are owned by the same person, provided that the royalty rights arise out of the production of the commodity underlying the commodity derivative contract.

(iv) Hedges of services. Short or long positions in commodity derivative contracts offset by the anticipated change in value of receipts or payments due or

expected to be due under an executed contract for services held by the same person, provided that the contract for services arises out of the production, manufacturing, processing, use, or transportation of the commodity underlying the commodity derivative contract, and which may not exceed one year for agricultural commodities.

(5) Cross-commodity hedges. Positions in commodity derivative contracts described in paragraph (2)(ii), paragraphs (3)(i) through (iv) and paragraphs (4)(i) through (iv) of this definition may also be used to offset the risks arising from a commodity other than the same cash commodity underlying a commodity derivative contract, provided that the fluctuations in value of the position in the commodity derivative contract, or the commodity underlying the commodity derivative contract, are substantially related to the fluctuations in value of the actual or anticipated cash position or pass-through swap and no such position is maintained in any physical-delivery commodity derivative contract during the lesser of the last five days of trading or the time period for the spot month in such physical-delivery contract.

Commodity derivative contract means, for this part, any futures, option, or swap contract in a commodity (other than a security futures product as defined in section 1a(45) of the Act).

Core referenced futures contract means a futures contract that is listed in §150.2(d).

Eligible affiliate. An eligible affiliate means an entity with respect to which another person:

(1) Directly or indirectly holds either:

(i) A majority of the equity securities of such entity, or

(ii) 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 Generally Accepted Accounting Principles or International Financial Reporting Standards, and such consolidated financial statements include the financial results of such entity; and

(3) Is required to aggregate the positions of such entity under §150.4 and does not claim an exemption from aggregation for such entity.

Eligible entity means a commodity pool operator; the operator of a trading vehicle which is excluded or which itself has qualified for exclusion from the definition of the term "pool" or "commodity pool operator," respectively, under §4.5 of this chapter; the limited partner, limited member or shareholder in a commodity pool the operator of which is exempt from registration under §4.13 of this chapter; a commodity trading advisor; a bank or trust company; a savings association; an insurance company; or the separately organized affiliates of any of the above entities:

(1) Which authorizes an independent account controller independently to control all trading decisions with respect to the eligible entity's client positions and accounts that the independent account controller holds directly or indirectly, or on the eligible entity's behalf, but without the eligible entity's day-to-day direction; and

(2) Which maintains:

(i) Only such minimum control over the independent account controller as is consistent with its fiduciary responsibilities to the managed positions and accounts, and necessary to fulfill its duty to supervise diligently the trading done on its behalf; or

(ii) If a limited partner, limited member or shareholder of a commodity pool the operator of which is exempt from registration under §4.13 of this chapter, only such limited control as is consistent with its status.

Entity means a "person" as defined in section 1a of the Act.

Excluded commodity means an "excluded commodity" as defined in section 1a of the Act.

Futures-equivalent means

(1) 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 open position in a core referenced futures contract.

Independent account controller means a person—

(1) Who specifically is authorized by an eligible entity, as defined in this section, independently to control trading decisions on behalf of, but without the day-to-day direction of, the eligible entity;

(2) Over whose trading the eligible entity maintains only such minimum control as is consistent with its fiduciary responsibilities for managed positions and accounts to fulfill its duty to supervise diligently the trading done on its behalf or as is consistent with such other legal rights or obligations which may be incumbent upon the eligible entity to fulfill;

(3) Who trades independently of the eligible entity and of any other independent account controller trading for the eligible entity;

(4) Who has no knowledge of trading decisions by any other independent account controller; and

(5) Who is

(i) Registered as a futures commission merchant, an introducing broker, a commodity trading advisor, or an associated person of any such registrant, or

(ii) A general partner, managing member or manager of a commodity pool the operator of which is excluded from registration under §4.5(a)(4) of this chapter or §4.13 of this chapter, provided that such general partner, managing member or manager complies with the requirements of §150.4(c).

Intermarket spread position means a long position in a commodity derivative contract in a particular commodity at a particular designated contract market or swap execution facility and a short position in another commodity derivative contract in that same commodity away from that particular designated contract market or swap execution facility.

Intramarket spread position means a long position in a commodity derivative contract in a particular commodity and a short position in another commodity derivative contract in the same commodity on the same designated contract market or swap execution facility.

Long position means a long call option, a short put option or a long underlying futures contract, or a long futures-equivalent swap.

Physical commodity means any agricultural commodity as that term is defined in §1.3 of this chapter or any exempt commodity as that term is defined in section 1a(20) of the Act.

Pre-enactment swap means any swap entered into prior to enactment of the Dodd-Frank Act of 2010 (July 21, 2010), the terms of which have not expired as of the date of enactment of that Act.

Pre-existing position means any position in a commodity derivative contract acquired in good faith prior to the effective date of any bylaw, rule, regulation or resolution that specifies an initial speculative position limit level or a subsequent change to that level.

Referenced contract means, on a futures equivalent basis with respect to a particular core referenced futures contract, a core referenced futures contract listed in §150.2(d), or a futures contract, options contract, or swap, and excluding any guarantee of a swap, a basis contract, or a commodity index contract:

(1) That is:

(i) 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; or

(ii) 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; and

(2) Where:

(i) Calendar spread contract means a cash-settled agreement, contract, or transaction that represents the difference between the settlement price in one or a series of contract months of an agreement, contract or transaction and the settlement price of another contract month or another series of contract months' settlement prices for the same agreement, contract or transaction;

(ii) 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;

(iii) Spread contract means either a calendar spread contract or an intercommodity spread contract; and

(iv) Intercommodity spread contract means a cash-settled agreement, contract or transaction that represents the difference between the settlement price of a referenced contract and the settlement price of another contract, agreement, or transaction that is based on a different commodity.

Short position means a short call option, a long put option or a short underlying futures contract, or a short futures-equivalent swap.

Speculative position limit means the maximum position, either net long or net 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, or a person's position in the spot month of commodity derivative contacts in a particular commodity. Such a limit

may be established under federal regulations or rules of a designated contract market or swap execution facility. An exchange may also apply other limits, such as a limit on gross long or gross short positions, or a limit on holding or controlling delivery instruments.

Spot month means—

(1) For physical-delivery commodity derivative contracts, the period of time beginning at the earlier of the close of trading on the trading day preceding the first day on which delivery notices can be issued to the clearing organization of a contract market, or the close of trading on the trading day preceding the third-to-last trading day, until the contract is no longer listed for trading (or available for transfer, such as through exchange for physical transactions).

(2) For cash-settled contracts, spot month means the period of time beginning at the earlier of the close of trading on the trading day preceding the period in which the underlying cash-settlement price is calculated, or the close of trading on the trading day preceding the third-to-last trading day, until the contract cash-settlement price is determined and published; provided however, if the cash-settlement 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 that core referenced futures contract.

Swap means "swap" as that term is defined in section 1a of the Act and as further defined in §1.3 of this chapter.

Swap dealer means "swap dealer" as that term is defined in section 1a of the Act and as further defined in §1.3 of this chapter.

Transition period swap means a swap entered into during the period commencing after the enactment of the Dodd-Frank Act of 2010 (July 21, 2010), and ending 60 days after the publication in the Federal Register of final amendments to part 150 of this chapter implementing section 737 of the Dodd-Frank Act of 2010.

23. Revise §150.2 to read as follows:

§150.2 Speculative position limits.

(a) Spot-month speculative position limits. No person may hold or control positions in referenced contracts in the spot month, net long or net short, in excess of the level specified by the Commission for:

(1) Physical-delivery referenced contracts; and, separately,

(2) Cash-settled referenced contracts;

(b) Single-month and all-months-combined speculative position limits. No person may hold or control positions, net long or net short, in referenced contracts in a single month or in all months combined (including the spot month) in excess of the levels specified by the Commission.

(c) For purposes of this part:

(1) The spot month and any single month shall be those of the core referenced futures contract; and

(2) An eligible affiliate is not required to comply separately with speculative position limits.

(d) Core referenced futures contracts. Speculative position limits apply to referenced contracts based on the core referenced futures contracts listed in the following table:

Core Referenced Futures Contracts

Commodity Type	Designated Contract Market	Core Referenced Futures Contract[1]
(1) Legacy Agricultural		
	Chicago Board of Trade	
		Corn (C)
		Oats (O)
		Soybeans (S)
		Soybean Meal (SM)
		Soybean Oil (SO)
		Wheat (W)
	Kansas City Board of Trade	
		Hard Winter Wheat (KW)
	ICE Futures U.S.	
		Cotton No. 2 (CT)
	Minneapolis Grain Exchange	
		Hard Red Spring Wheat (MWE)
(2) Other Agricultural		
	Chicago Board of Trade	
		Rough Rice (RR)
	Chicago Mercantile Exchange	
		Class III Milk (DA)
		Feeder Cattle (FC)
		Lean Hog (LH)
		Live Cattle (LC)
	ICE Futures U.S.	

Commodity Type	Designated Contract Market	Core Referenced Futures Contract[1]
		Cocoa (CC)
		Coffee C (KC)
		FCOJ-A (OJ)
		U.S. Sugar No. 11 (SB)
		U.S. Sugar No. 16 (SF)
(3) Energy		
	New York Mercantile Exchange	
		Light Sweet Crude Oil (CL)
		NY Harbor ULSD (HO)
		RBOB Gasoline (RB)
		Henry Hub Natural Gas (NG)
(4) Metals		
	Commodity Exchange, Inc.	
		Gold (GC)
		Silver (SI)
		Copper (HG)
	New York Mercantile Exchange	
		Palladium (PA)
		Platinum (PL)

[1] The core referenced futures contract includes any successor contracts.

(e) Levels of speculative position limits. (1) Initial levels. The initial levels of speculative position limits are fixed by the Commission at the levels listed in Appendix D of this part and shall be effective 60 days after publication in the Federal Register.

(2) Subsequent levels. (i) The Commission shall fix subsequent levels of speculative position limits in accordance with the procedures in this section and publish such levels on the Commission's Web site at http://www.cftc.gov.

(ii) Such subsequent speculative position limit levels shall each apply beginning on the close of business of the last business day of the second complete calendar month after publication of such levels; provided however, if such close of business is in a spot month of a core referenced futures contract, the subsequent spot-month level shall apply beginning with the next spot month for that contract.

(iii) All subsequent levels of speculative position limits shall be rounded up to the nearest hundred contracts.

(3) Procedure for computing levels of spot-month limits. (i) No less frequently than every two calendar years, the Commission shall fix the level of the spot-month limit no greater than one-quarter of the estimated spot-month deliverable supply in the relevant core referenced futures contract. Unless the Commission determines to rely on its own estimate of deliverable supply, the Commission shall utilize the estimated spot-month deliverable supply provided by a designated contract market.

(ii) Each designated contract market in a core referenced futures contract shall supply to the Commission an estimated spot-month deliverable supply. A designated contract market may use the guidance regarding deliverable supply in Appendix C of part 38 of this chapter. Each estimate must be accompanied by a description of the methodology used to derive the estimate and any statistical data supporting the estimate, and must be submitted no later than the following:

(A) For energy commodities, January 31 of the second calendar year following the most recent Commission action establishing such limit levels;

(B) For metals commodities, March 31 of the second calendar year following the most recent Commission action establishing such limit levels;

(C) For legacy agricultural commodities, May 31 of the second calendar year following the most recent Commission action establishing such limit levels; and

(D) For other agricultural commodities, August 31 of the second calendar year following the most recent Commission action establishing such limit levels.

(4) Procedure for computing levels of single-month and all-months-combined limits. No less frequently than every two calendar years, the Commission shall fix the level, for each referenced contract, of the single-month limit and the all-months-combined limit. Each such limit shall be based on 10 percent of the estimated average open interest in referenced contracts, up to 25,000 contracts, with a marginal increase of 2.5 percent thereafter.

(i) Time periods for average open interest. The Commission shall estimate average open interest in referenced contracts based on the largest annual average open interest computed for each of the past two calendar years. The Commission may estimate average open interest in referenced contracts using either month-end open contracts or open contracts for each business day in the time period, as practical.

(ii) Data sources for average open interest. The Commission shall estimate average open interest in referenced contracts using data reported to the Commission pursuant to part 16 of this chapter, and open swaps reported to the Commission pursuant to part 20 of this chapter or data obtained by the Commission from swap data repositories

collecting data pursuant to part 45 of this chapter. Options listed on designated contract markets shall be adjusted using an option delta reported to the Commission pursuant to part 16 of this chapter. Swaps shall be counted on a futures equivalent basis, equal to the economically equivalent amount of core referenced futures contracts reported pursuant to part 20 of this chapter or as calculated by the Commission using swap data collected pursuant to part 45 of this chapter.

(iii) Publication of average open interest. The Commission shall publish estimates of average open interest in referenced contracts on a monthly basis, as practical, after such data is submitted to the Commission.

(iv) Minimum levels. Provided however, notwithstanding the above, the minimum levels shall be the greater of the level of the spot month limit determined under paragraph (e)(3) of this section and 1,000 for referenced contracts in an agricultural commodity or 5,000 for referenced contracts in an exempt commodity.

(f) Pre-existing Positions—(1) Pre-existing positions in a spot-month. Other than pre-enactment and transition period swaps exempted under §150.3(d), a person shall comply with spot month speculative position limits.

(2) Pre-existing positions in a non-spot-month. A single-month or all-months-combined speculative position limit established under this section shall not apply to any commodity derivative contract acquired in good faith prior to the effective date of such limit, provided, however, that if such position is not a pre-enactment or transition period swap then that position shall be attributed to the person if the person's position is increased after the effective date of such limit.

(g) Positions on Foreign Boards of Trade. The aggregate speculative position limits established under this section shall apply to a person with positions in referenced contracts executed on, or pursuant to the rules of a foreign board of trade, provided that:

(1) Such referenced contracts settle against any price (including the daily or final settlement price) of one or more contracts listed for trading on a designated contract market or swap execution facility that is a trading facility; and

(2) The foreign board of trade makes available such referenced contracts to its members or other participants located in the United States through direct access to its electronic trading and order matching system.

(h) Anti-evasion provision. For the purposes of applying the speculative position limits in this section, a commodity index contract used to circumvent speculative position limits shall be considered to be a referenced contract.

(1) Delegation of authority to the Director of the Division of Market Oversight. (i) The Commission hereby delegates, until it orders otherwise, to the Director of the Division of Market Oversight or such other employee or employees as the Director may designate from time to time, the authority in paragraph (e) of this section to fix and publish subsequent levels of speculative position limits.

(ii) The Director of the Division of Market Oversight may submit to the Commission for its consideration any matter which has been delegated in this section.

(iii) Nothing in this section prohibits the Commission, at its election, from exercising the authority delegated in this section.

(iv) The Commission will periodically update these initial levels for speculative position limits and publish such subsequent levels on its web site at: http://www.cftc.gov.

(2) Reserved.

24. Revise §150.3 to read as follows:

§150.3 Exemptions.

(a) Positions which may exceed limits. The position limits set forth in §150.2 may be exceeded to the extent that:

(1) Such positions are:

(i) Bona fide hedging positions as defined in §150.1, provided that for anticipatory bona fide hedge positions under paragraphs (3)(iii), (4)(i), (4)(iii), and (4)(iv) of the bona fide hedging position definition in §150.1 the person complies with the filing procedure found in §150.7;

(ii) Financial distress positions exempted under paragraph (b) of this section;

(iii) Conditional spot-month limit positions exempted under paragraph (c) of this section; or

(iv) Other positions exempted under paragraph (e) of this section; and that

(2) The recordkeeping requirements of paragraph (g) of this section are met; and further that

(3) The reporting requirements of part 19 of this chapter are met.

(b) Financial distress exemptions. Upon specific request made to the Commission, the Commission may exempt a person or related persons under financial distress circumstances for a time certain from any of the requirements of this part.

Financial distress circumstances include situations involving the potential default or bankruptcy of a customer of the requesting person or persons, an affiliate of the requesting person or persons, or a potential acquisition target of the requesting person or persons.

(c) Conditional spot-month limit exemption. The position limits set forth in §150.2 may be exceeded for cash-settled referenced contracts provided that such positions do not exceed five times the level of the spot-month limit specified by the Commission and the person holding or controlling such positions does not hold or control positions in spot-month physical-delivery referenced contracts.

(d) Pre-enactment and transition period swaps exemption. The speculative position limits set forth in §150.2 shall not apply to positions acquired in good faith in any pre-enactment swap, or in any transition period swap, in either case as defined by §150.1, provided, however, that a person may net such positions with post-effective date commodity derivative contracts for the purpose of complying with any non-spot-month speculative position limit.

(e) Other exemptions. Any person engaging in risk-reducing practices commonly used in the market, which they believe may not be specifically enumerated in the definition of bona fide hedging position in §150.1, may request:

(1) An interpretative letter from Commission staff, under §140.99 of this chapter, concerning the applicability of the bona fide hedging position exemption; or

(2) Exemptive relief from the Commission under section 4a(a)(7) of the Act.

(3) Appendix C of this part provides a non-exhaustive list of examples of bona fide hedging positions as defined under §150.1.

(f) Previously granted exemptions. Exemptions granted by the Commission under §1.47 of this chapter for swap risk management shall not apply to swap positions entered into after the effective date of initial position limits implementing section 737 of the Dodd-Frank Act of 2010.

(g) Recordkeeping. (1) Persons who avail themselves of exemptions under this section, including exemptions granted under section 4a(a)(7) of the Act, shall keep and maintain complete books and records concerning all details of their related cash, forward, futures, futures options and swap positions and transactions, including anticipated requirements, production and royalties, contracts for services, cash commodity products and by-products, and cross-commodity hedges, and shall make such books and records, including a list of pass-through swap counterparties, available to the Commission upon request under paragraph (h) of this section.

(2) Further, a party seeking to rely upon the pass-through swap offset in paragraph (2)(ii) of the definition of "bona fide hedging position" in §150.1, in order to exceed the position limits of §150.2 with respect to such a swap, may only do so if its counterparty provides a written representation (e.g., in the form of a field or other representation contained in a mutually executed trade confirmation) that, as to such counterparty, the swap qualifies in good faith as a "bona fide hedging position," as defined in §150.1, at the time the swap was executed. That written representation shall be retained by the parties to the swap for a period of at least two years following the expiration of the swap and furnished to the Commission upon request.

(3) Any person that represents to another person that a swap qualifies as a pass-through swap under paragraph (2)(ii) of the definition of "bona fide hedging position" in

§150.1 shall keep and make available to the Commission upon request all relevant books and records supporting such a representation for a period of at least two years following the expiration of the swap.

(h) Call for information. Upon call by the Commission, the Director of the Division of Market Oversight or the Director's delegate, any person claiming an exemption from speculative position limits under this section must provide to the Commission such information as specified in the call relating to the positions owned or controlled by that person; trading done pursuant to the claimed exemption; the commodity derivative contracts or cash market positions which support the claim of exemption; and the relevant business relationships supporting a claim of exemption.

(i) Aggregation of accounts. Entities required to aggregate accounts or positions under §150.4 shall be considered the same person for the purpose of determining whether they are eligible for a bona fide hedging position exemption under paragraph (a)(1)(i) of this section with respect to such aggregated account or position.

(j) Delegation of authority to the Director of the Division of Market Oversight. (1) The Commission hereby delegates, until it orders otherwise, to the Director of the Division of Market Oversight or such other employee or employees as the Director may designate from time to time, the authority in paragraph (b) of this section to provide exemptions in circumstances of financial distress.

(2) The Director of the Division of Market Oversight may submit to the Commission for its consideration any matter which has been delegated in this section.

(3) Nothing in this section prohibits the Commission, at its election, from exercising the authority delegated in this section.

25. Revise §150.5 to read as follows:

§150.5 Exchange-set speculative position limits.

(a) Requirements and acceptable practices for commodity derivative contracts subject to federal position limits. (1) For any commodity derivative contract that is subject to a speculative position limit under §150.2, the designated contract market or swap execution facility that is a trading facility shall set a speculative position limit no higher than the level specified in §150.2.

(2) Exemptions. (i) Hedge exemption. Any hedge exemption rules adopted by a designated contract markets or a swap execution facility that is a trading facility must conform to the definition of bona fide hedging position in §150.1.

(ii) Other exemptions. In addition to the express exemptions specified in §150.3, a designated contract market or swap execution facility that is a trading facility may grant other exemptions for:

(A) Intramarket spread positions as defined in §150.1, provided that such positions must be outside of the spot month for physical-delivery contracts and must not exceed the all-months limit set forth in §150.2 when combined with any other net positions in the single month;

(B) Intermarket spread positions as defined in §150.1, provided that such positions must be outside of the spot month for physical-delivery contracts.

(iii) Application for exemption. Traders must apply to the designated contract market or swap execution facility that is a trading facility for any exemption from its speculative position limit rules. The designated contract market or swap execution facility that is a trading facility may limit bona fide hedging positions, or any other

positions that have been exempted pursuant to §150.3, which it determines are not in accord with sound commercial practices, or which exceed an amount that may be established and liquidated in an orderly fashion.

(3) Pre-enactment and transition period swap positions. Speculative position limits set forth in §150.2 shall not apply to positions acquired in good faith in any pre-enactment swap, or in any transition period swap, in either case as defined by §150.1. Provided, however, that a designated contract market or swap execution facility that is a trading facility shall allow a person to net such position with post-effective date commodity derivative contracts for the purpose of complying with any non-spot-month speculative position limit.

(4) Pre-existing positions. (i) Pre-existing positions in a spot-month. A designated contract market or swap execution facility that is a trading facility must require compliance with spot month speculative position limits for pre-existing positions in commodity derivative contracts other than pre-enactment and transition period swaps.

(ii) Pre-existing positions in a non-spot-month. A single-month or all-months-combined speculative position limit established under §150.2 shall not apply to any commodity derivative contract acquired in good faith prior to the effective date of such limit, provided, however, that such position shall be attributed to the person if the person's position is increased after the effective date of such limit.

(5) Aggregation. Designated contract markets and swap execution facilities that are trading facilities must have aggregation rules that conform to §150.4.

(6) Additional acceptable practices. A designated contract market or swap execution facility that is a trading facility may:

(i) Impose additional restrictions on a person with a long position in the spot month of a physical-delivery contract who stands for delivery, takes that delivery, then re-establishes a long position;

(ii) Establish limits on the amount of delivery instruments that a person may hold in a physical-delivery contract; and

(iii) Impose such other restrictions as it deems necessary to reduce the potential threat of market manipulation or congestion, to maintain orderly execution of transactions, or for such other purposes consistent with its responsibilities.

(b) Requirements and acceptable practices for commodity derivative contracts that are not subject to the limits set forth in §150.2, including derivative contracts in a physical commodity as defined in §150.1 and in an excluded commodity as defined in section 1a(19) of the Act—(1) Levels at initial listing. At the time of each commodity derivative contract's initial listing, a designated contract market or swap execution facility that is a trading facility should base speculative position limits on the following:

(i) Spot month position limits. (A) Commodities with a measurable deliverable supply. For all commodity derivative contracts not subject to the limits set forth in §150.2 that are based on a commodity with a measurable deliverable supply, the spot month limit level should be established at a level that is no greater than one-quarter of the estimated spot month deliverable supply, calculated separately for each month to be listed (Designated Contract Markets and Swap Execution Facilities may refer to the guidance in paragraph (b)(1)(i) of Appendix C of part 38 for guidance on estimating spot-month deliverable supply);

(B) Commodities without a measurable deliverable supply. For commodity derivative contracts that are based on a commodity with no measurable deliverable supply, the spot month limit level should be set at a level that is necessary and appropriate to reduce the potential threat of market manipulation or price distortion of the contract's or the underlying commodity's price or index.

(ii) Individual non-spot or all-months-combined position limits. (A) Agricultural commodity derivative contracts. For agricultural commodity derivative contracts not subject to the limits set forth in §150.2, the individual non-spot or all-months-combined levels should be no greater than 1,000 contracts, when the notional quantity per contract is no larger than a typical cash market transaction in the underlying commodity. If the notional quantity per contract is larger than the typical cash market transaction, then the individual non-spot month limit or all-months combined limit level should be scaled down accordingly. If the commodity derivative contract is substantially the same as a pre-existing designated contract market or swap execution facility commodity derivative contract, then the designated contract or swap execution facility may adopt the same limit as applies to that pre-existing commodity derivative contract;

(B) Exempt or excluded commodity derivative contracts. For exempt commodity derivative contracts not subject to the limits set forth in §150.2 or excluded commodity derivative contracts, the individual non-spot or all-months-combined levels should be no greater than 5,000 contracts, when the notional quantity per contract is no larger than a typical cash market transaction in the underlying commodity. If the notional quantity per contract is larger than the typical cash market transaction, then the individual non-spot month limit or all-months combined limit level should be scaled down accordingly. If

the commodity derivative contract is substantially the same as a pre-existing commodity derivative contract, then the designated contract market or swap execution facility may adopt the same limit as applies to that pre-existing commodity derivative contract.

(iii) Commodity derivative contracts that are cash-settled by referencing a daily settlement price of an existing contract. For commodity derivative contracts that are cash-settled by referencing a daily settlement price of an existing contract listed on a designated contract market or swap execution facility that is a trading facility, the cash-settled contract should adopt the same spot-month, individual non-spot-month, and all-months-combined position limits as the original price referenced contract.

(2) Adjustments to levels. Designated contract markets and swap execution facilities that are trading facilities should adjust their speculative limit levels as follows:

(i) Spot month position limits. The spot month position limit level should be reviewed no less than once every twenty-four months from the date of initial listing and should be maintained at a level that is:

(A) No greater than one-quarter of the estimated spot month deliverable supply, calculated separately for each month to be listed; or

(B) In the case of a commodity derivative contract based on a commodity without a measurable deliverable supply, necessary and appropriate to reduce the potential threat of market manipulation or price distortion of the contract's or the underlying commodity's price or index.

(ii) Individual non-spot or all-months-combined position limits. Individual non-spot or all-months-combined levels should be no greater than 10% of the average combined futures and delta-adjusted option month-end open interest for the most recent

calendar year up to 25,000 contracts, with a marginal increase of 2.5% thereafter, or be based on position sizes customarily held by speculative traders on the contract market. In any case, such levels should be reviewed no less than once every twenty-four months from the date of initial listing.

(3) Position accountability in lieu of speculative position limits. A designated contract market or swap execution facility that is a trading facility may adopt a bylaw, rule, regulation, or resolution, substituting for the exchange set speculative position limits specified under this paragraph (b), an exchange rule requiring traders to consent to provide information about their position upon request by the exchange and to consent to halt increasing further a trader's position or to reduce their positions in an orderly manner, in each case upon request by the exchange as follows:

(i) Physical commodity derivative contracts. On a physical commodity derivative contract that is not subject to the limits set forth in §150.2, having an average month-end open interest of 50,000 contracts and an average daily volume of 5,000 or more contracts during the most recent calendar year and a liquid cash market, a designated contract market or swap execution facility that is a trading facility may adopt individual non-spot month or all-months-combined position accountability levels, provided, however, that such designated contract market or swap execution facility that is a trading facility should adopt a spot month speculative position limit with a level no greater than one-quarter of the estimated spot month deliverable supply;

(ii) Excluded commodity derivative contracts—(A) Spot month. On an excluded commodity derivative contract for which there is a highly liquid cash market and no legal impediment to delivery, a designated contract market or swap execution facility that is a

trading facility may adopt position accountability in lieu of position limits in the spot month. For an excluded commodity derivative contract based on a commodity without a measurable deliverable supply, a designated contract market or swap execution facility that is a trading facility may adopt position accountability in lieu of position limits in the spot month. For all other excluded commodity derivative contracts, a designated contract market or swap execution facility that is a trading facility should adopt a spot-month position limit with a level no greater than one-quarter of the estimated deliverable supply;

(B) Individual non-spot or all-months-combined position limits. On an excluded commodity derivative contract, a designated contract market or swap execution facility that is a trading facility may adopt position accountability levels in lieu of position limits in the individual non-spot month or all-months-combined.

(iii) New commodity derivative contracts that are substantially the same as an existing contract. On a new commodity derivative contract that is substantially the same as an existing commodity derivative contract listed for trading on a designated contract market or swap execution facility that is a trading facility, which has adopted position accountability in lieu of position limits, the designated contract market or swap execution facility may adopt for the new contract when it is initially listed for trading the position accountability levels of the existing contract.

(4) Calculation of trading volume and open interest. For purposes of this paragraph, trading volume and open interest should be calculated by:

(i) Open interest. (A) Averaging the month-end open positions in a futures contract and its related option contract, on a delta-adjusted basis, for all months listed during the most recent calendar year; and

(B) Averaging the month-end futures-equivalent amount of open positions in swaps in a particular commodity (such as, for swaps that are not referenced contracts, by combining the notional month-end open positions in swaps in a particular commodity, including options in that same commodity that are swaps on a delta-adjusted basis, and dividing by a notional quantity per contract that is no larger than a typical cash market transaction in the underlying commodity).

(ii) Trading volume. (A) Counting the number of contracts in a futures contract and its related option contract, on a delta-adjusted basis, transacted during the most recent calendar year; and

(B) Counting the futures-equivalent number of swaps in a particular commodity transacted during the most recent calendar year.

(5) Exemptions—(i) Hedge exemption. Any hedge exemption rules adopted by a designated contract market or a swap execution facility that is a trading facility must conform to the definition of bona fide hedging position in §150.1.

(ii) Other exemptions. In addition to the exemptions for bona fide hedging positions that conform to paragraph (b)(5)(i) of this section, a designated contract market or swap execution facility that is a trading facility may grant other exemptions for:

(A) Financial distress. Upon specific request made to the designated contract market or swap execution facility that is a trading facility, the designated contract market or swap execution facility that is a trading facility may exempt a person or related persons under financial distress circumstances for a time certain from any of the requirements of this part. Financial distress circumstances include situations involving the potential default or bankruptcy of a customer of the requesting person or persons, an

affiliate of the requesting person or persons, or a potential acquisition target of the requesting person or persons;

(B) Conditional spot-month limit exemption. Exchange-set speculative position limits may be exceeded for cash-settled contracts provided that such positions should not exceed five times the level of the spot-month limit specified by the designated contract market or swap execution facility that is a trading facility and the person holding or controlling such positions should not hold or control positions in referenced spot-month physical-delivery contracts;

(C) Intramarket spread positions as defined in §150.1, provided that such positions should be outside of the spot month for physical-delivery contracts and should not exceed the all-months limit when combined with any other net positions in the single month;

(D) Intermarket spread positions as defined in §150.1, provided that such positions should be outside of the spot month for physical-delivery contracts; and/or

(E) For excluded commodities, a designated contract market or swap execution facility that is a trading facility may grant a limited risk management exemption pursuant to rules submitted to the Commission, consistent with the guidance in Appendix A of this part.

(iii) Application for exemption. Traders must apply to the designated contract market or swap execution facility that is a trading facility for any exemption from its speculative position limit rules. In considering whether to grant such an application for exemption, a designated contract market or swap execution facility that is a trading facility should take into account whether the requested exemption is in accord with sound

commercial practices and results in a position that does not exceed an amount that may be established and liquidated in an orderly fashion.

(6) Pre-enactment and transition period swap positions. Speculative position limits should not apply to positions acquired in good faith in any pre-enactment swap, or in any transition period swap, in either case as defined by §150.1. Provided, however, that a designated contract market or swap execution facility that is a trading facility may allow a person to net such position with post-effective date commodity derivative contracts for the purpose of complying with any non-spot-month speculative position limit.

(7) Pre-existing positions—(i) Pre-existing positions in a spot-month. A designated contract market or swap execution facility that is a trading facility should require compliance with spot month speculative position limits for pre-existing positions in commodity derivative contracts other than pre-enactment and transition period swaps.

(ii) Pre-existing positions in a non-spot-month. A single-month or all-months-combined speculative position limit should not apply to any commodity derivative contract acquired in good faith prior to the effective date of such limit, provided, however, that such position should be attributed to the person if the person's position is increased after the effective date of such limit.

(8) Aggregation. Designated contract markets and swap execution facilities that are trading facilities must have aggregation rules that conform to §150.4.

(9) Additional acceptable practices. Particularly in the spot month, a designated contract market or swap execution facility that is a trading facility may:

(i) Impose additional restrictions on a person with a long position in the spot month of a physical-delivery contract who stands for delivery, takes that delivery, then re-establishes a long position;

(ii) Establish limits on the amount of delivery instruments that a person may hold in a physical-delivery contract; and

(iii) Impose such other restrictions as it deems necessary to reduce the potential threat of market manipulation or congestion, to maintain orderly execution of transactions, or for such other purposes consist with its responsibilities.

(c) Securities futures products. For security futures products, position limitations and position accountability provisions are specified in §41.25(a)(3) of this chapter.

26. Revise §150.6 to read as follows:

§150.6 Ongoing application of the Act and Commission regulations.

This part shall only be construed as having an effect on position limits set by the Commission or a designated contract market or swap execution facility. Nothing in this part shall be construed to affect any other provisions of the Act or Commission regulations including but not limited to those relating to manipulation, attempted manipulation, corners, squeezes, fraudulent or deceptive conduct or prohibited transactions.

27. Add §150.7 to read as follows:

§150.7 Requirements for anticipatory bona fide hedging position exemptions.

(a) Statement. Any person who wishes to avail himself of exemptions for unfilled anticipated requirements, unsold anticipated production, anticipated royalties, anticipated services contract payments or receipts, or anticipatory cross-commodity hedges under the

provisions of paragraphs (3)(iii), (4)(i), (4)(iii), (4)(iv), or (5), respectively, of the definition of bona fide hedging position in §150.1 shall file Form 704 with the Commission in advance of the date the person expects to exceed the position limits established under this part. Filings in conformity with the requirements of this section shall be effective ten days after submission, unless otherwise notified by the Commission.

(b) Commission notification. At any time, the Commission may, by notice to any person filing a Form 704, specify its determination as to what portion, if any, of the amounts described in such filing does not meet the requirements for bona fide hedging positions. In no case shall such person's anticipatory bona fide hedging positions exceed the levels specified in paragraph (f) of this section.

(c) Call for additional information. At any time, the Commission may request a person who has on file a Form 704 under paragraph (a) of this section to file specific additional or updated information with the Commission to support a determination that the Form 704 on file accurately reflects unsold anticipated production, unfilled anticipated requirements, anticipated royalties, or anticipated services contract payments or receipts.

(d) Initial statement. Initial Form 704 concerning the classification of positions as bona fide hedging pursuant to paragraphs (3)(iii), or (4)(i), (4)(iii), (4)(iv) or anticipatory cross-commodity hedges under paragraph (5) of the definition of bona fide hedging position in §150.1 shall be filed with the Commission at least ten days in advance of the date that such positions would be in excess of limits then in effect pursuant to section 4a of the Act. Such statements shall set forth in detail for a specified operating period, not in excess of one year for an agricultural commodity, the person's anticipated activity, i.e.,

unfilled anticipated requirements, unsold anticipated production, anticipated royalties, or anticipated services contract payments or receipts, and explain the method of determination thereof, including, but not limited to, the following information:

(1) Anticipated activity. For each anticipated activity:

(i) The type of cash commodity underlying the anticipated activity;

(ii) The name of the actual cash commodity underlying the anticipated activity and the units in which the cash commodity is measured;

(iii) An indication of whether the cash commodity is the same commodity (grade and quality) that underlies a core referenced futures contract or whether a cross-hedge will be used and, if so, additional information for cross hedges specified in paragraph (d)(2) of this section;

(iv) Annual production, requirements, royalty receipts or service contract payments or receipts, in terms of futures equivalents, of such commodity for the three complete fiscal years preceding the current fiscal year;

(v) The specified time period for which the anticipatory hedge exemption is claimed;

(vi) Anticipated production, requirements, royalty receipts or service contract payments or receipts, in terms of futures equivalents, of such commodity for such specified time period, not in excess of one year for an agricultural commodity;

(vii) Fixed-price forward sales, inventory, and fixed-price forward purchases of such commodity, including any quantity in process of manufacture and finished goods and byproducts of manufacture or processing (in terms of such commodity);

(viii) Unsold anticipated production, unfilled anticipated requirements, unsold anticipated royalty receipts,, and anticipated service contract payments or receipts the risks of which have not been offset with cash positions, of such commodity for the specified time period, not in excess of one year for an agricultural commodity; and

(ix) The maximum number of long positions and short positions in referenced contracts expected to be used to offset the risks of such anticipated activity.

(2) Additional information for cross hedges. Cash positions that represent a commodity, or products or byproducts of a commodity, that is different from the commodity underlying a commodity derivative contract that is expected to be used for hedging, shall be shown both in terms of the equivalent amount of the commodity underlying the commodity derivative contract used for hedging and in terms of the actual cash commodity as provided for on Form 704. In computing their cash position, every person shall use such standards and conversion factors that are usual in the particular trade or that otherwise reflect the value-fluctuation-equivalents of the cash position in terms of the commodity underlying the commodity derivative contract used for hedging. Such person shall furnish to the Commission upon request detailed information concerning the basis for and derivation of such conversion factors, including:

(i) The hedge ratio used to convert the actual cash commodity to the equivalent amount of the commodity underlying the commodity derivative contract used for hedging; and

(ii) An explanation of the methodology used for determining the hedge ratio.

(e) Supplemental reports. Whenever the amount which a person wishes to consider as a bona fide hedging position shall exceed the amount in the most recent filing

pursuant to this section or such lesser amount as determined by the Commission pursuant to paragraph (b) of this section, such person shall file with the Commission a Form 704 which updates the information provided in the person's most recent filing and supplies the reason for this change at least ten days in advance of the date that person wishes to exceed such amount.

(f) Annual update. Each person that has filed an initial statement on Form 704 for an anticipatory bona fide hedge exemption shall provide annual updates on the utilization of the anticipatory exemption. Each person shall report actual cash activity utilizing the anticipatory exemption for the preceding year, as well as the cumulative utilization since the filing of the initial or most recent supplemental statement. Each person shall also provide a good faith estimate of the remaining anticipatory exemption. Such reports shall set forth in detail the person's activity related to the anticipated exemption and shall include, but not be limited to the following information:

(1) Information to be included:. For each anticipated activity:

(i) The type of cash commodity underlying the anticipated activity;

(ii) The name of the actual cash commodity underlying the anticipated activity and the units in which the cash commodity is measured;

(iii) An indication of whether the cash commodity is the same commodity (grade and quality) that underlies a core referenced futures contract or whether a cross-hedge will be used and, if so, additional information for cross hedges specified in paragraph (d)(2) of this section;

(iv) Actual production, requirements, royalty receipts or service contract payments or receipts, in terms of futures equivalents, of such commodity for the reporting month;

(v) Cumulative actual production, requirements, royalty receipts or service contract payments or receipts, in terms of futures equivalents, of such commodity since the initial or supplemental statement;

(vi) Estimated anticipated production, requirements, royalty receipts or service contract payments or receipts, in terms of futures equivalents, of such commodity for the remainder of such specified time period, not in excess of one year for an agricultural commodity;

(vii) Fixed-price forward sales, inventory, and fixed-price forward purchases of such commodity, including any quantity in process of manufacture and finished goods and byproducts of manufacture or processing (in terms of such commodity) for the reporting month;

(viii) Remaining unsold anticipated production, unfilled anticipated requirements, unsold anticipated royalty receipts, and anticipated service contract payments or receipts the risks of which have not been offset with cash positions, of such commodity for the specified time period, not in excess of one year for an agricultural commodity; and

(ix) The maximum number of long positions and short positions in referenced contracts expected to be used to offset the risks of such anticipated activity for the remainder of the specified time period.

(2) Reserved.

(g) Monthly reporting. Monthly reporting of remaining anticipated hedge exemption shall be reported on Form 204, along with reporting other exemptions pursuant to §19.01(a)(3)(vii).

(h) Maximum sales and purchases. Sales or purchases of commodity derivative contracts considered to be bona fide hedging positions under paragraphs (3)(iii)(A) or (4)(i) of the bona fide hedging position definition in §150.1 shall at no time exceed the lesser of:

(1) A person's anticipated activity (including production, requirements, royalties and services) as described by the information most recently filed pursuant to this section that has not been offset with cash positions; or

(2) Such lesser amount as determined by the Commission pursuant to paragraph (b) of this section.

(i) Delegation of authority to the Director of the Division of Market Oversight. (1) The Commission hereby delegates, until it orders otherwise, to the Director of the Division of Market Oversight or such other employee or employees as the Director may designate from time to time, the authority:

(i) In paragraph (b) of this section to provide notice to a person that some or all of the amounts described in a Form 704 filing does not meet the requirements for bona fide hedging positions;

(ii) In paragraph (c) of this section to request a person who has filed a Form 704 under paragraph (a) of this section to file specific additional or updated information with the Commission to support a determination that the Form 704 filed accurately reflects

unsold anticipated production, unfilled anticipated requirements, anticipated royalties, or anticipated services contract payments or receipts; and

(iii) In paragraph (d)(2) of this section to request detailed information concerning the basis for and derivation of conversion factors used in computing the cash position provided in Form 704.

(2) The Director of the Division of Market Oversight may submit to the Commission for its consideration any matter which has been delegated in this section.

(3) Nothing in this section prohibits the Commission, at its election, from exercising the authority delegated in this section.

28. Add §150.8 to read as follows:

<u>§150.8 Severability.</u>

If any provision of this part, or the application thereof to any person or circumstances, is held invalid, such invalidity shall not affect other provisions or application of such provision to other persons or circumstances which can be given effect without the invalid provision or application.

29. Add appendix A to part 150 to read as follows:

Appendix A to Part 150 – Guidance on Risk Management Exemptions for Commodity Derivative Contracts in Excluded Commodities.

(1) This appendix provides non-exclusive interpretative guidance on risk management exemptions for commodity derivative contracts in excluded commodities permitted under the definition of bona fide hedging position in §150.1. The rules of a designated contract market or swap execution facility that is a trading facility may recognize positions consistent with this guidance as bona fide hedging positions. The

Commission recognizes that risk reducing positions in commodity derivative contracts in excluded commodities may not conform to the general definition of bona fide hedging positions applicable to commodity derivative contracts in physical commodities, as provided under section 4a(c)(2) of the Act, and may not conform to enumerated bona fide hedging positions applicable to commodity derivative contracts in physical commodities under the definition of bona fide hedging position in §150.1.

This interpretative guidance for core principle 5 for designated contract markets, section 5(d)(5) of the Act, and core principle 6 for swap execution facilities that are trading facilities, section 5h(f)(6) of the Act, is illustrative only of the types of positions for which a trading facility may elect to provide a risk management exemption and is not intended to be used as a mandatory checklist. Other positions might also be included appropriately within a risk management exemption.

(2)(a) No temporary substitute criterion. Risk management positions in commodity derivative contracts in excluded commodities need not be expected to represent a substitute for a subsequent transaction or position in a physical marketing channel. There need not be any requirement to replace a commodity derivative contract with a cash market position in order to qualify for a risk management exemption.

(b) Cross-commodity hedging is permitted. Risks that are offset in commodity derivative contracts in excluded commodities need not arise from the same commodities underlying the commodity derivative contracts. For example, a trading facility may recognize a risk management exemption based on the net interest rate risk arising from a bank's balance sheet of loans and deposits that is offset using Treasury security futures contracts or short-term interest rate futures contracts.

(3) Examples of risk management positions. This section contains examples of risk management positions that may be economically appropriate to the reduction of risk in the operation of a commercial enterprise.

(a) Balance sheet hedging. A commercial enterprise may have risks arising from its net position in assets and liabilities.

(i) Foreign currency translation. Once form of balance sheet hedging involves offsetting net exposure to changes in currency exchange rates for the purpose of stabilizing the domestic dollar accounting value of net assets and/or liabilities which are denominated in a foreign currency. For example, a bank may make loans in a foreign currency and take deposits in that same foreign currency. Such a bank is exposed to net foreign currency translation risk when the amount of loans is not equal to the amount of deposits. A bank with a net long exposure to a foreign currency may hedge by establishing an offsetting short position in a foreign currency commodity derivative contract.

(ii) Interest rate risk. Another form of balance sheet hedging involves offsetting net exposure to changes in values of assets and liabilities of differing durations. Examples include:

(A) A pension fund may invest in short term securities and have longer term liabilities. Such a pension fund has a duration mismatch. Such a pension fund may hedge by establishing a long position in Treasury security futures contracts to lengthen the duration of its assets to match the duration of its liabilities. This is economically equivalent to using a long position in Treasury security futures contracts to shorten the duration of its liabilities to match the duration of its assets.

(B) A bank may make a certain amount of fixed-rate loans of one maturity and fund such assets through taking fixed-rate deposits of a shorter maturity. Such a bank is exposed to interest rate risk, in that an increase in interest rates may result in a greater decline in value of the assets than the decline in value of the deposit liabilities. A bank may hedge by establishing a short position in short-term interest rate futures contracts to lengthen the duration of its liabilities to match the duration of its assets. This is economically equivalent to using a short position in short-term interest rate futures contracts, for example, to shorten the duration of its assets to match the duration of its liabilities.

(b) Unleveraged synthetic positions. An investment fund may have risks arising from a delayed investment in an asset allocation promised to investors. Such a fund may synthetically gain exposure to an asset class using a risk management strategy of establishing a long position in commodity derivative contracts that does not exceed cash set aside in an identifiable manner, including short-term investments, any funds deposited as margin and accrued profits on such commodity derivative contract positions. For example:

(i) A collective investment fund that invests funds in stocks pursuant to an asset allocation strategy may obtain immediate stock market exposure upon receipt of new monies by establishing a long position in stock index futures contracts ("equitizing cash"). Such a long position may qualify as a risk management exemption under trading facility rules provided such long position does not exceed the cash set aside. The long position in stock index futures contracts need not be converted to a position in stock.

(ii) Upon receipt of new funds from investors, an insurance company that invests in bond holdings for a separate account wishes to lengthen synthetically the duration of the portfolio by establishing a long position in Treasury futures contracts. Such a long position may qualify as a risk management exemption under trading facility rules provided such long position does not exceed the cash set aside. The long position in Treasury futures contracts need not be converted to a position in bonds.

(c) Temporary asset allocations. A commercial enterprise may have risks arising from potential transactional costs in temporary asset allocations (altering portfolio exposure to certain asset classes such as equity securities and debt securities). Such an enterprise may hedge existing assets owned by establishing a short position in an appropriate commodity derivative contract and synthetically gain exposure to an alternative asset class using a risk management strategy of establishing a long position in another commodity derivative contract that does not exceed: the value of the existing asset at the time the temporary asset allocation is established or, in the alternative, the hedged value of the existing asset plus any accrued profits on such risk management positions. For example:

(i) A collective investment fund that invests funds in bonds and stocks pursuant to an asset allocation strategy may believe that market considerations favor a temporary increase in the fund's equity exposure relative to its bond holdings. The fund manager may choose to accomplish the reallocation using commodity derivative contracts, such as a short position in Treasury security futures contracts and a long position in stock index futures contracts. The short position in Treasury security futures contracts may qualify as a hedge of interest rate risk arising from the bond holdings. A trading facility may adopt

rules to recognize as a risk management exemption such a long position in stock index futures.

(ii) Reserved.

(4) Clarification of bona fides of short positions.

(a) Calls sold. A seller of a call option establishes a short call option. A short call option is a short position in a commodity derivative contract with respect to the underlying commodity. A bona fide hedging position includes such a written call option that does not exceed in quantity the ownership or fixed-price purchase contracts in the contract's underlying cash commodity by the same person.

(b) Puts purchased and portfolio insurance. A buyer of a put option establishes a long put option. However, a long put option is a short position in a commodity derivative contract with respect to the underlying commodity. A bona fide hedging position includes such an owned put that does not exceed in quantity the ownership or fixed-price purchase contracts in the contract's underlying cash commodity by the same person.

The Commission also recognizes as bona fide hedging positions strategies that provide protection against a price decline equivalent to an owned position in a put option for an existing portfolio of securities owned. A dynamically managed short position in a futures contract may replicate the characteristics of a long position in a put option. Hedgers are reminded of their obligation to enter and exit the market in an orderly manner.

(c) Synthetic short futures contracts. A person may establish a synthetic short futures position by purchasing a put option and selling a call option, when each option has the same notional amount, strike price, expiration date and underlying commodity.

Such a synthetic short futures position is a short position in a commodity derivative contract with respect to the underlying commodity. A bona fide hedging position includes such a synthetic short futures position that does not exceed in quantity the ownership or fixed-price purchase contracts in the contract's underlying cash commodity by the same person.

30. Add appendix B to part 150 to read as follows:

Appendix B to Part 150 – Commodities Listed as Substantially the Same for Purposes of the Definition of Basis Contract

The following table lists core referenced futures contracts and commodities that are treated as substantially the same as a commodity underlying a core referenced futures contract for purposes of the definition of basis contract in §150.1.

BASIS CONTRACT LIST OF SUBSTANTIALLY THE SAME COMMODITIES

Core Referenced Futures Contract	Commodities Considered Substantially the Same (regardless of location)	Source(s) for Specification of Quality
NYMEX Light Sweet Crude Oil futures contract (CL)		
	1. Light Louisiana Sweet (LLS) Crude Oil	NYMEX Argus LLS vs. WTI (Argus) Trade Month futures contract (E5)
		NYMEX LLS (Argus) vs. WTI Financial futures contract (WJ)
		ICE Futures Europe Crude Diff—Argus LLS vs WTI 1st Line Swap futures contract (ARK)
		ICE Futures Europe Crude Diff—Argus LLS vs WTI Trade Month Swap futures contract (ARL)
NYMEX New York Harbor ULSD Heating Oil futures contract (HO)		
	1. Chicago ULSD	NYMEX Chicago ULSD (Platts) vs.

Core Referenced Futures Contract	Commodities Considered Substantially the Same (regardless of location)	Source(s) for Specification of Quality
		NY Harbor ULSD Heating Oil futures contract (5C)
	2. Gulf Coast ULSD	NYMEX Group Three ULSD (Platts) vs. NY Harbor ULSD Heating Oil futures contract (A6)
		NYMEX Gulf Coast ULSD (Argus) Up-Down futures contract (US)
		NYMEX Gulf Coast ULSD (Argus) Up-Down BALMO futures contract (GUD)
		NYMEX Gulf Coast ULSD (Platts) Up-Down BALMO futures contract (1L)
		NYMEX Gulf Coast ULSD (Platts) Up-Down Spread futures contract (LT)
		ICE Futures Europe Diesel Diff- Gulf Coast vs Heating Oil 1st Line Swap futures contract (GOH)
		CME Clearing Europe Gulf Coast ULSD(Platts) vs. New York Heating Oil (NYMEX) Spread Calendar swap (ELT)
		CME Clearing Europe New York Heating Oil (NYMEX) vs. European Gasoil (IC) Spread Calendar swap (EHA)
	3. California Air Resources Board Spec ULSD (CARB no. 2 oil)	NYMEX Los Angeles CARB Diesel (OPIS) vs. NY Harbor ULSD Heating Oil futures contract (KL)
	4. Gas Oil Deliverable in Antwerp, Rotterdam, or Amsterdam Area	ICE Futures Europe Gasoil futures contract (G)
		ICE Futures Europe Heating Oil Arb—Heating Oil 1st Line vs Gasoil 1st Line Swap futures contract (HOT)
		ICE Futures Europe Heating Oil Arb—Heating Oil 1st Line vs Low Sulphur Gasoil 1st Line Swap futures contract (ULL)
		NYMEX NY Harbor ULSD Heating Oil vs. Gasoil futures contract (HA)
NYMEX RBOB Gasoline futures contract (RB)		
	1. Chicago Unleaded 87 gasoline	

Core Referenced Futures Contract	Commodities Considered Substantially the Same (regardless of location)	Source(s) for Specification of Quality
		NYMEX Chicago Unleaded Gasoline (Platts) vs. RBOB Gasoline futures contract (3C)
		NYMEX Group Three Unleaded Gasoline (Platts) vs. RBOB Gasoline futures contract (A8)
	2. Gulf Coast Conventional Blendstock for Oxygenated Blending (CBOB) 87	
		NYMEX Gulf Coast CBOB Gasoline A1 (Platts) vs. RBOB Gasoline futures contract (CBA)
		NYMEX Gulf Coast Unl 87 (Argus) Up-Down futures contract (UZ)
	3. Gulf Coast CBOB 87 (Summer Assessment)	
		NYMEX Gulf Coast CBOB Gasoline A2 (Platts) vs. RBOB Gasoline futures contract (CRB)
	4. Gulf Coast Unleaded 87 (Summer Assessment)	
		NYMEX Gulf Coast 87 Gasoline M2 (Platts) vs. RBOB Gasoline futures contract (RVG)
		NYMEX Gulf Coast 87 Gasoline M2 (Platts) vs. RBOB Gasoline BALMO futures contract (GBB)
		NYMEX Gulf Coast 87 Gasoline M2 (Argus) vs. RBOB Gasoline BALMO futures contract (RBG)
	5. Gulf Coast Unleaded 87	
		NYMEX Gulf Coast Unl 87 (Platts) Up-Down BALMO futures contract (1K)
		NYMEX Gulf Coast Unl 87 Gasoline M1 (Platts) vs. RBOB Gasoline futures contract (RV)
		CME Clearing Europe Gulf Coast Unleaded 87 Gasoline M1 (Platts) vs. New York RBOB Gasoline (NYMEX) Spread Calendar swap (ERV)
	6. Los Angeles California Reformulated Blendstock for Oxygenate Blending (CARBOB) Regular	

Core Referenced Futures Contract	Commodities Considered Substantially the Same (regardless of location)	Source(s) for Specification of Quality
		NYMEX Los Angeles CARBOB Gasoline (OPIS) vs. RBOB Gasoline futures contract (JL)
	7. Los Angeles California Reformulated Blendstock for Oxygenate Blending (CARBOB) Premium	
		NYMEX Los Angeles CARBOB Gasoline (OPIS) vs. RBOB Gasoline futures contract (JL)
	8. Euro-BOB OXY NWE Barges	
		NYMEX RBOB Gasoline vs. Euro-bob Oxy NWE Barges (Argus) (1000mt) futures contract (EXR)
		CME Clearing Europe New York RBOB Gasoline (NYMEX) vs. European Gasoline Euro-bob Oxy Barges NWE (Argus) (1000mt) Spread Calendar swap (EEXR)
	9. Euro-BOB OXY FOB Rotterdam	
		ICE Futures Europe Gasoline Diff—RBOB Gasoline 1st Line vs. Argus Euro-BOB OXY FOB Rotterdam Barge Swap futures contract (ROE)

31. Add appendix C to part 150 to read as follows:

Appendix C to Part 150 – Examples of Bona Fide Hedging Positions for Physical Commodities

A non-exhaustive list of examples meeting the definition of bona fide hedging position under §150.1 is presented below. With respect to a position that does not fall within an example in this appendix, a person seeking to rely on a bona fide hedging position exemption under §150.3 may seek guidance from the Division of Market Oversight. References to paragraphs in the examples below are to the definition of bona fide hedging position in §150.1.

1. Portfolio hedge under paragraph (3)(i) of the bona fide hedging position definition

Fact Pattern: It is currently January and Participant A owns seven million bushels of corn located in its warehouses. Participant A has entered into fixed-price forward sale contracts with several processors for a total of five million bushels of corn that will be delivered by May of this year. Participant A has no fixed-price corn purchase contracts. Participant A's gross long cash position is equal to seven million bushels of corn. Because Participant A has sold forward five million bushels of corn, its net cash position is equal to long two million bushels of corn. To reduce price risk associated with potentially lower corn prices, Participant A chooses to establish a short position of 400 contracts in the CBOT Corn futures contract, equivalent to two million bushels of corn, in the same crop year as the inventory.

Analysis: The short position in a contract month in the current crop year for the CBOT Corn futures contract, equivalent to the amount of inventory held, satisfies the general requirements for a bona fide hedging position under paragraphs (2)(i)(A)-(C) and the provisions associated with owning a commodity under paragraph (3)(i).[1] Because the firm's net cash position is two million bushels of unsold corn, the firm is exposed to price risk. Participant A's hedge of the two million bushels represents a substitute for a fixed-price forward sale at a later time in the physical marketing channel. The position is economically appropriate to the reduction of price risk because the short position in a

[1] Participant A could also choose to hedge on a gross basis. In that event, Participant A could establish a short position in the March Chicago Board of Trade Corn futures contract equivalent to seven million bushels of corn to offset the price risk of its inventory and establish a long position in the May Chicago Board of Trade Corn futures contract equivalent to five million bushels of corn to offset the price risk of its fixed-price forward sale contracts.

referenced contract does not exceed the quantity equivalent risk exposure (on a net basis) in the cash commodity in the current crop year. Last, the hedge arises from a potential change in the value of corn owned by Participant A.

2. Lending a commodity and hedge of price risk under paragraph (3)(i) of the bona fide hedging position definition

Fact Pattern: Bank B owns 1,000 ounces of gold that it lends to Jewelry Fabricator J at LIBOR plus a differential. Under the terms of the loan, Jewelry Fabricator J may later purchase the gold from Bank B at a differential to the prevailing price of the Commodity Exchange, Inc. (COMEX) Gold futures contract (i.e., an open-price purchase agreement is embedded in the terms of the loan). Jewelry Fabricator J intends to use the gold to make jewelry and reimburse Bank B for the loan using the proceeds from jewelry sales and either purchase gold from Bank B by paying the market price for gold or return the equivalent amount of gold to Bank B by purchasing gold at the market price. Because Bank B has retained the price risk on gold, the bank is concerned about its potential loss if the price of gold drops. The bank reduces the risk of a potential loss in the value of the gold by establishing a ten contract short position in the COMEX Gold futures contract, which has a unit of trading of 100 ounces of gold. The ten contract short position is equivalent to 1,000 ounces of gold.

Analysis: This position meets the general requirements for bona fide hedging positions under paragraphs (2)(i)(A)-(C) and the requirements associated with owning a cash commodity under paragraph (3)(i). The physical commodity that is being hedged is the underlying cash commodity for the COMEX Gold futures contract. Bank B's short hedge of the gold represents a substitute for a transaction to be made in the physical

marketing channel (e.g., completion of the open-price sale to Jewelry Fabricator J). Because the notional quantity of the short position in the gold futures contract is equal to the amount of gold that Bank B owns, the hedge is economically appropriate to the reduction of risk. Finally, the short position in the commodity derivative contract offsets the potential change in the value of the gold owned by Bank B.

3. Repurchase agreements and hedge of inventory under paragraph (3)(i) of the bona fide hedging position definition

Fact Pattern: Elevator A purchased 500,000 bushels of wheat in April and reduced its price risk by establishing a short position of 100 contracts in the CBOT Wheat futures contract, equivalent to 500,000 bushels of wheat. Because the price of wheat rose steadily since April, Elevator A had to make substantial maintenance margin payments. To alleviate its cash flow concern about meeting further margin calls, Elevator A decides to enter into a repurchase agreement with Bank B and offset its short position in the wheat futures contract. The repurchase agreement involves two separate contracts: a fixed-price sale from Elevator A to Bank B at today's spot price; and an open-price purchase agreement that will allow Elevator A to repurchase the wheat from Bank B at the prevailing spot price three months from now. Because Bank B obtains title to the wheat under the fixed-price purchase agreement, it is exposed to price risk should the price of wheat drop. Bank B establishes a short position of 100 contracts in the CBOT Wheat futures contract, equivalent to 500,000 bushels of wheat.

Analysis: Bank B's position meets the general requirements for a bona fide hedging position under paragraphs (2)(i)(A)-(C) and the provisions for owning the cash commodity under paragraph (3)(i). The short position in referenced contracts by Bank B

is a substitute for a fixed-price sales transaction to be taken at a later time in the physical marketing channel either to Elevator A or to another commercial party. The position is economically appropriate to the reduction of risk in the conduct and management of the commercial enterprise (Bank B) because the notional quantity of the short position in referenced contracts held by Bank B is not larger than the quantity of cash wheat purchased by Bank B. Finally, the short position in the CBOT Wheat futures contract reduces the price risk associated with owning cash wheat.

4. Utility hedge of anticipated customer requirements under paragraph (3)(iii)(B) of the bona fide hedging position definition

Fact Pattern: Natural Gas Utility A is encouraged to hedge its purchases of natural gas by the State Public Utility Commission in order to reduce natural gas price risk to residential customers. State Public Utility Commission considers the hedging practice to be prudent and allows gains and losses from hedging to be passed on to Natural Gas Utility A's regulated natural gas customers. Natural Gas Utility A has about one million residential customers who have average historical usage of about 71.5 mmBTUs of natural gas per year per residence. The utility decides to hedge about 70 percent of its residential customers' anticipated requirements for the following year, equivalent to a 5,000 contract long position in the NYMEX Henry Hub Natural Gas futures contract. To reduce the risk of higher prices to residential customers, Natural Gas Utility A establishes a 5,000 contract long position in the NYMEX Henry Hub Natural Gas futures contract. Since the utility is only hedging 70 percent of historical usage, Natural Gas Utility A is highly certain that realized demand will exceed its hedged anticipated residential customer requirements.

Analysis: Natural Gas Utility A's position meets the general requirements for a bona fide hedging position under paragraphs (2)(i)(A)-(C) and the provisions for hedges of unfilled anticipated requirements by a utility under paragraph (3)(iii)(B). The physical commodity that is being hedged involves a commodity underlying the NYMEX Henry Hub Natural Gas futures contract. The long position in the commodity derivative contract represents a substitute for transactions to be taken at a later time in the physical marketing channel. The position is economically appropriate to the reduction of price risk because the price of natural gas may increase. The commodity derivative contract position offsets the price risk of natural gas that the utility anticipates purchasing on behalf of its residential customers. As provided under paragraph (3)(iii), the risk-reducing position qualifies as a bona fide hedging position in the natural gas physical-delivery referenced contract during the spot month provided that the position does not exceed the unfilled anticipated requirements for that month and for the next succeeding month.

5. Processor margins hedge using unfilled anticipated requirements under paragraph (3)(iii)(A) of the bona fide hedging position definition and anticipated production under paragraph (4)(i) of the definition

Fact Pattern: Soybean Processor A has a total throughput capacity of 200 million bushels of soybeans per year (equivalent to 40,000 CBOT soybean futures contracts). Soybean Processor A crushes soybeans into products (soybean oil and soybean meal). It currently has 40 million bushels of soybeans in storage and has offset that risk through fixed-price forward sales of the amount of products expected to be produced from crushing 40 million bushels of soybeans, thus locking in its processor margin on one

million metric tons of soybeans. Because it has consistently operated its plants at full capacity over the last three years, it anticipates purchasing another 160 million bushels of soybeans to be delivered to its storage facility over the next year. It has not sold the 160 million bushels of anticipated production of crushed products forward. Processor A faces the risk that the difference in price relationships between soybeans and the crushed products (i.e., the crush spread) could change adversely, resulting in reduced anticipated processing margins. To hedge its processing margins and lock in the crush spread, Processor A establishes a long position of 32,000 contracts in the CBOT Soybean futures contract (equivalent to 160 million bushels of soybeans) and corresponding short positions in CBOT Soybean Meal and Soybean Oil futures contracts, such that the total notional quantity of soybean meal and soybean meal futures contracts are equivalent to the expected production from crushing 160 million bushels of soybeans into soybean meal and soybean oil.

Analysis: These positions meet the general requirements for bona fide hedging positions under paragraphs (2)(i)(A)-(C) and the provisions for hedges of unfilled anticipated requirements under paragraph (3)(iii)(A) and unsold anticipated production under paragraph (4)(i). The physical commodities being hedged are commodities underlying the CBOT Soybean, Soybean Meal, and Soybean Oil futures contracts. Long positions in the soybean futures contract and corresponding short positions in soybean meal and soybean oil futures contracts qualify as bona fide hedging positions provided they do not exceed the unfilled anticipated requirements of the cash commodity for twelve months (in this case 4 million tons) as required in paragraph (3)(iii)(A) and the quantity equivalent of twelve months unsold anticipated production of cash products and

by-products as required in paragraph (4)(i). Such positions are a substitute for purchases and sales to be made at a later time in the physical marketing channel and are economically appropriate to the reduction of risk. The positions in referenced contracts offset the potential change in the value of soybeans that the processor anticipates purchasing and the potential change in the value of products and by-products the processor anticipates producing and selling. The size of the permissible long hedge position in the soybean futures contract must be reduced by any inventories and fixed-price purchases because they would reduce the processor's unfilled requirements. Similarly, the size of the permissible short hedge positions in soybean meal and soybean oil futures contracts must be reduced by any fixed-price sales because they would reduce the processor's unsold anticipated production. As provided under paragraph (3)(iii)(A), the risk reducing long position in the soybean futures contract that is not in excess of the anticipated requirements for soybeans for that month and the next succeeding month qualifies as a bona fide hedging position during the last five days of trading in the physical-delivery referenced contract. As provided under paragraph (4)(i), the risk reducing short position in the soybean meal and oil futures contract do not qualify as a bona fide hedging position in a physical-delivery referenced contract during the last five days of trading in the event the Soybean Processor A does not have unsold products in inventory.

The combination of the long and short positions in soybean, soybean meal, and soybean oil futures contracts are economically appropriate to the reduction of risk. However, unlike in this example, an unpaired position (e.g., only a long position in a commodity derivative contract) that is not offset by either a cash market position (e.g., a

fixed-price sales contract) or derivative position (e.g., a short position in a commodity derivative contract) would not represent an economically appropriate reduction of risk. This is because the commercial enterprise's crush spread risk is relatively low in comparison to the price risk from taking an outright long position in the futures contract in the underlying commodity or an outright short position in the futures contracts in the products and by-products of processing. The price fluctuations of the crush spread, that is, the risk faced by the commercial enterprise, would not be expected to be substantially related to the price fluctuations of either an outright long or outright short futures position.

6. Agent hedge under paragraph (3)(iv) of the bona fide hedging position definition

Fact Pattern: Agent A is in the business of merchandising (selling) the cash grain owned by multiple warehouse operators and forwarding the merchandising revenues back to the warehouse operators less the agent's fees. Agent A does not own any cash commodity, but is responsible for merchandising of the cash grain positions of the warehouse operators pursuant to contractual arrangements. The contractual arrangements also authorize Agent A to hedge the price risks of the grain owned by the warehouse operators. For the volumes of grain it is authorized to hedge, the agent enters into short positions in grain commodity derivative contracts that offset the price risks of the cash commodities.

Analysis: The positions meet the requirements of paragraphs (2)(1)(A)-(C) for hedges of a physical commodity and paragraph (3)(iv) for hedges by an agent. The positions represent a substitute for transactions to be made in the physical marketing

channel, are economically appropriate to the reduction of risks arising from grain owned by the agent's contractual counterparties, and arise from the potential change in the value of such grain. The agent does not own and has not contacted to purchase such grain at a fixed price, but is responsible for merchandising the cash positions that are being offset in commodity derivative contracts. The agent has a contractual arrangement with the persons who own the grain being offset.

7. Sovereign hedge of unsold anticipated production under paragraph (4)(i) of the bona fide hedging position definition and position aggregation under §150.4

Fact Pattern: A Sovereign induces a farmer to sell his anticipated production of 100,000 bushels of corn forward to User A at a fixed price for delivery during the expected harvest. In return for the farmer entering into the fixed-price forward sale, the Sovereign agrees to pay the farmer the difference between the market price at the time of harvest and the price of the fixed-price forward, in the event that the market price at the time of harvest is above the price of the forward. The fixed-price forward sale of 100,000 bushels of corn reduces the farmer's downside price risk associated with his anticipated agricultural production. The Sovereign faces commodity price risk as it stands ready to pay the farmer the difference between the market price and the price of the fixed-price contract. To reduce that risk, the Sovereign establishes a long position of 20 call options on the Chicago Board of Trade (CBOT) Corn futures contract, equivalent to 100,000 bushels of corn.

Analysis: Because the Sovereign and the farmer are acting together pursuant to an express agreement, the aggregation provisions of §150.4 apply and they are treated as a single person for purposes of position limits. Taking the positions of the Sovereign and

farmer jointly, the risk profile of the combination of the forward sale and the long call is approximately equivalent to the risk profile of a synthetic long put.[2] A synthetic long put offsets the downside price risk of anticipated production. Thus, the position of that person satisfies the general requirements for a bona fide hedging position under paragraphs (2)(i)(A)-(C) and meets the requirements for anticipated agricultural production under paragraph (4)(i). The agreement between the Sovereign and the farmer involves the production of a commodity underlying the CBOT Corn futures contract. The synthetic long put is a substitute for transactions that the farmer has made in the physical marketing channel. The synthetic long put reduces the price risk associated with anticipated agricultural production. The size of the Sovereign's position is equivalent to the size of the farmer's anticipated production. As provided under paragraph (4), the Sovereign's risk-reducing position would not qualify as a bona fide hedging position in a physical-delivery futures contract during the last five days of trading; however, since the CBOT Corn option will exercise into a physical-delivery CBOT Corn futures contract prior to the last five days of trading in that physical-delivery futures contract, the Sovereign may continue to hold its option position as a bona fide hedging position through option expiry.

8. Hedge of offsetting unfixed price sales and purchases under paragraph (4)(ii) of the bona fide hedging position definition

Fact Pattern: Currently it is October and Oil Merchandiser A has entered into cash forward contracts to purchase 600,000 of crude oil at a floating price that references the January contract month (in the next calendar year) for the ICE Futures Brent Crude

[2] Put-call parity describes the mathematical relationship between price of a put and call with identical strike prices and expiry.

futures contract and to sell 600,000 barrels of crude oil at a price that references the February contract month (in the next calendar year) for the NYMEX Light Sweet Crude Oil futures contract. Oil Merchandiser A is concerned about an adverse change in the price spread between the January ICE Futures Brent Crude futures contract and the February NYMEX Light Sweet Crude Oil futures contract. To reduce that risk, Oil Merchandiser A establishes a long position of 600 contracts in the January ICE Futures Brent Crude futures contract, price risk equivalent to buying 600,000 barrels of oil, and a short position of 600 contracts in the February NYMEX Light Sweet Crude Oil futures contract, price risk equivalent to selling 600,000 barrels of oil.

Analysis: Oil Merchandiser A's positions meet the general requirements for bona fide hedging positions under paragraphs (2)(i)(A)-(C) and the provisions for offsetting sales and purchases in referenced contracts under paragraph (4)(ii). The physical commodity that is being hedged involves a commodity underlying the NYMEX Light Sweet Crude Oil futures contract. The long and short positions in commodity derivative contracts represent substitutes for transactions to be taken at a later time in the physical marketing channel. The positions are economically appropriate to the reduction of risk because the price spread between the ICE Futures Brent Crude futures contract and the NYMEX Light Sweet Crude Oil futures contract could move adversely to Oil Merchandiser A's interests in the two cash forward contracts, that is, the price of the ICE Futures Brent Crude futures contract could increase relative to the price of the NYMEX Light Sweet Crude Oil futures contract. The positions in commodity derivative contracts offset the price risk in the cash forward contracts. As provided under paragraph (4), the

risk-reducing position does not qualify as a bona fide hedging position in the crude oil physical-delivery referenced contract during the spot month.

9. Anticipated royalties hedge under paragraph (4)(iii) of the bona fide hedging position definition and pass-through swaps hedge under paragraph (2)(ii) of the definition

a. Fact Pattern: In order to develop an oil field, Company A approaches Bank B for financing. To facilitate the loan, Bank B first establishes an independent legal entity commonly known as a special purpose vehicle (SPV). Bank B then provides a loan to the SPV. The SPV is obligated to repay principal and interest to the Bank based on a fixed price for crude oil. The SPV in turn makes a production loan to Company A. The terms of the production loan require Company A to provide the SPV with volumetric production payments (VPPs) based on a specified share of the production to be sold at the prevailing price of crude oil (i.e., the index price) as oil is produced. Because the price of crude oil may fall, the SPV reduces that risk by entering into a crude oil swap with Swap Dealer C. The swap requires the SPV to pay Swap Dealer C the floating price of crude oil (i.e., the index price) and for Swap Dealer C to pay a fixed price to the SPV. The notional quantity for the swap is equal to the expected production underlying the VPPs to the SPV. The SPV will receive a floating price at index on the VPP and will pay a floating price at index on the swap, which will offset. The SPV will receive a fixed price payment on the swap and repay the loan's principal and interest to Bank B. The SPV is highly certain that the VPP production volume will occur, since the SPV's engineer has reviewed the forecasted production from Company A and required the VPP volume to be set with a cushion (i.e., a hair-cut) below the forecasted production.

Analysis: For the SPV, the swap between Swap Dealer C and the SPV meets the general requirements for a bona fide hedging position under paragraphs (2)(i)(A)-(C) and the requirements for anticipated royalties under paragraph (4)(iii). The SPV will receive payments under the VPP royalty contract based on the unfixed price sale of anticipated production of the physical commodity underlying the royalty contract, i.e., crude oil. The swap represents a substitute for the price of sales transactions to be made in the physical marketing channel. The SPV's swap position qualifies as a hedge because it is economically appropriate to the reduction of price risk. The swap reduces the price risk associated with a change in value of a royalty asset. The fluctuations in value of the SPV's anticipated royalties are substantially related to the fluctuations in value of the crude oil swap with Swap Dealer C.

b. Continuation of Fact Pattern: Swap Dealer C offsets the price risk associated with the swap to the SPV by establishing a short position in cash-settled crude oil futures contracts. The notional quantity of the short position in futures contracts held by Swap Dealer C exactly matches the notional quantity of the swap with the SPV.

Analysis: For the swap dealer, because the SPV enters the cash-settled swap as a bona fide hedger under paragraph (4)(iii) (i.e., a pass-through swap counterparty), the offset of the risk of the swap in a futures contract by Swap Dealer C qualifies as a bona fide hedging position (i.e., a pass-through swap offset) under paragraph (2)(ii)(A). Since the swap was executed opposite a pass-through swap counterparty and was offset, the swap itself also qualifies as a bona fide hedging position (i.e., a pass-through swap) under paragraph (2)(ii)(B). If the cash-settled swap is not a referenced contract, then the pass-through swap offset may qualify as a cross-commodity hedge under paragraph (5),

provided the fluctuations in value of the pass-through swap offset are substantially related to the fluctuations in value of the pass-through swap.

10. Anticipated royalties hedge under paragraph (4)(iii) of the bona fide hedging position definition and cross-commodity hedge under paragraph (5) of the definition

Fact Pattern: An eligible contract participant (ECP) owns royalty interests in a portfolio of oil wells. Royalties are paid at the prevailing (floating) market price for the commodities produced and sold at major trading hubs, less transportation and gathering charges. The large portfolio and well-established production history for most of the oil wells provide a highly certain production stream for the next 24 months. The ECP also determined that changes in the cash market prices of 50 percent of the oil production underlying the portfolio of royalty interests historically have been closely correlated with changes in the calendar month average of daily settlement prices of the nearby NYMEX Light Sweet Crude Oil futures contract. The ECP decided to hedge some of the royalty price risk by entering into a cash-settled swap with a term of 24 months. Under terms of the swap, the ECP will receive a fixed payment and make monthly payments based on the calendar month average of daily settlement prices of the nearby NYMEX Light Sweet Crude Oil futures contract and notional amounts equal to 50 percent of the expected production volume of oil underlying the royalties.

Analysis: This position meets the requirements of paragraphs (2)(i)(A)-(C) for hedges of a physical commodity, paragraph (4)(iii) for hedges of anticipated royalties, and paragraph (5) for cross-commodity hedges. The long position in the commodity derivative contract represents a substitute for transactions to be taken at a later time in the

physical marketing channel. The position is economically appropriate to the reduction of price risk because the price of oil may decrease. The commodity derivative contract position offsets the price risk of royalty payments, based on oil production, that the ECP anticipates receiving. The ECP is exposed to price risk arising from the anticipated production volume of oil attributable to her royalty interests. The physical commodity underlying the royalty portfolio that is being hedged involves a commodity with fluctuations in value that are substantially related to the fluctuations in value of the swap.

11. Hedges of services under paragraph (4)(iv) of the bona fide hedging position definition

a. Fact Pattern: Company A enters into a risk service agreement to drill an oil well with Company B. The risk service agreement provides that a portion of the revenue receipts to Company A depends on the value of the light sweet crude oil produced. Company A is exposed to the risk that the price of oil may fall, resulting in lower anticipated revenues from the risk service agreement. To reduce that risk, Company A establishes a short position in the New York Mercantile Exchange (NYMEX) Light Sweet Crude Oil futures contract, in a notional amount equivalent to the firm's anticipated share of the expected quantity of oil to be produced. Company A is highly certain of its anticipated share of the expected quantity of oil to be produced.

Analysis: Company A's hedge of a portion of its revenue stream from the risk service agreement meets the general requirements for bona fide hedging positions under paragraphs (2)(i)(A)-(C) and the provisions for services under paragraph (4)(iv). The contract for services involves the production of a commodity underlying the NYMEX Light Sweet Crude Oil futures contract. A short position in the NYMEX Light Sweet

Crude Oil futures contract is a substitute for transactions to be taken at a later time in the physical marketing channel, with the value of the revenue receipts to Company A dependent on the price of the oil sales in the physical marketing channel. The short position in the futures contract held by Company A is economically appropriate to the reduction of risk, because the total notional quantity underlying the short position in the futures contract held by Company A is equivalent to its share of the expected quantity of future production under the risk service agreement. Because the price of oil may fall, the short position in the futures contract reduces price risk from a potential reduction in the payments to Company A under the service contract with Company B. Under paragraph (4)(iv), the risk-reducing position will not qualify as a bona fide hedging position during the spot month of the physical-delivery oil futures contract.

b. Fact Pattern: A City contracts with Firm A to provide waste management services. The contract requires that the trucks used to transport the solid waste use natural gas as a power source. According to the contract, the City will pay for the cost of the natural gas used to transport the solid waste by Firm A. In the event that natural gas prices rise, the City's waste transport expenses will increase. To mitigate this risk, the City establishes a long position in the NYMEX Henry Hub Natural Gas futures contract in an amount equivalent to the expected volume of natural gas to be used over the life of the service contract.

Analysis: This position meets the general requirements for bona fide hedging positions under paragraphs (2)(i)(A)-(C) and the provisions for services under paragraph (4)(iv). The contract for services involves the use of a commodity underlying the NYMEX Henry Hub Natural Gas futures contract. Because the City is responsible for

paying the cash price for the natural gas used under the services contract, the long hedge is a substitute for transactions to be taken at a later time in the physical marketing channel. The position is economically appropriate to the reduction of price risk because the total notional quantity of the long position in a commodity derivative contract equals the expected volume of natural gas to be used over the life of the contract. The position in the commodity derivative contract reduces the price risk associated with an increase in anticipated costs that the City may incur under the services contract in the event that the price of natural gas increases. As provided under paragraph (4), the risk reducing position will not qualify as a bona fide hedge during the spot month of the physical-delivery futures contract.

12. Cross-commodity hedge under paragraph (5) of the bona fide hedging position definition and inventory hedge under paragraph (3)(i) of the definition

Fact Pattern: Copper Wire Fabricator A is concerned about possible reductions in the price of copper. Currently it is November and it owns inventory of 100 million pounds of copper and five million pounds of finished copper wire. Currently, deferred futures prices are lower than the nearby futures price. Copper Wire Fabricator A expects to sell 150 million pounds of finished copper wire in February of the following year. To reduce its price risk, Copper Wire Fabricator A establishes a short position of 6000 contracts in the February COMEX Copper futures contract, equivalent to selling 150 million pounds of copper. The fluctuations in value of copper wire are expected to be substantially related to fluctuations in value of copper.

Analysis: The Copper Wire Fabricator A's position meets the general requirements for a bona fide hedging position under paragraphs (2)(i)(A)-(C) and the

provisions for owning a commodity under paragraph (3)(i) and for a cross-hedge of the finished copper wire under paragraph (5). The short position in a referenced contract represents a substitute for transactions to be taken at a later time in the physical marketing channel. The short position is economically appropriate to the reduction of price risk in the conduct and management of the commercial enterprise because the price of copper could drop. The short position in the referenced contract offsets the risk of a possible reduction in the value of the inventory that it owns. Since the finished copper wire is a product of copper that is not deliverable on the commodity derivative contract, 200 contracts of the short position are a cross-commodity hedge of the finished copper wire and 400 contracts of the short position are a hedge of the copper inventory.

13. Cross-commodity hedge under paragraph (5) of the bona fide hedging position definition and anticipated requirements hedge under paragraph (3)(iii)(A) of the definition

Fact Pattern: Airline A anticipates using a predictable volume of jet fuel every month based on scheduled flights and decides to hedge 80 percent of that volume for each of the next 12 months. After a review of various commodity derivative contract hedging strategies, Airline A decides to cross hedge its anticipated jet fuel requirements in ultra-low sulfur diesel (ULSD) commodity derivative contracts. Airline A determined that price fluctuations in its average cost for jet fuel were substantially related to the price fluctuations of the calendar month average of the first nearby physical-delivery NYMEX New York Harbor ULSD Heating Oil (HO) futures contract and determined an appropriate hedge ratio, based on a regression analysis, of the HO futures contract to the quantity equivalent amount of its anticipated requirements. Airline A decided that it

would use the HO futures contract to cross hedge part of its jet fuel price risk. In addition, Airline A decided to protect against jet fuel price increases by cross hedging another part of its anticipated jet fuel requirements with a long position in cash-settled calls in the NYMEX Heating Oil Average Price Option (AT) contract. The AT call option is settled based on the price of the HO futures contract. The sum of the notional amounts of the long position in AT call options and the long position in the HO futures contract will not exceed the quantity equivalent of 80 percent of Airline A's anticipated requirements for jet fuel.

Analysis: The positions meet the requirements of paragraphs (2)(i)(A)-(C) for hedges of a physical commodity, paragraph (3)(iii)(A) for unfilled anticipated requirements and paragraph (5) for cross-commodity hedges. The positions represent a substitute for transactions to be made in the physical marketing channel, are economically appropriate to the reduction of risks arising from anticipated requirements for jet fuel, and arise from the potential change in the value of such jet fuel. The aggregation notional amount of the airline's positions in the call option and the futures contract does not exceed the quantity equivalent of anticipated requirements for jet fuel. The value fluctuations in jet fuel are substantially related to the value fluctuations in the HO futures contract.

Airline A may hold its long position in the cash-settled AT call option contract as a cross hedge against jet fuel price risk without having to exit the contract during the spot month.

14. Position aggregation under §150.4 and inventory hedge under paragraph (3)(i) of the bona fide hedging position definition

Fact Pattern: Company A owns 100 percent of Company B. Company B buys and sells a variety of agricultural products, including wheat. Company B currently owns five million bushels of wheat. To reduce some of its price risk, Company B establishes a short position of 600 contracts in the CBOT Wheat futures contract, equivalent to three million bushels of wheat. After communicating with Company B, Company A establishes an additional short position of 400 CBOT Wheat futures contracts, equivalent to two million bushels of wheat.

Analysis: The aggregate short position in the wheat referenced contract held by Company A and Company B meets the general requirements for a bona fide hedging position under paragraphs (2)(i)(A)-(C) and the provisions for owning a cash commodity under paragraph (3)(i). Because Company A owns more than 10 percent of Company B, Company A and B are aggregated together as one person under §150.4. Entities required to aggregate accounts or positions under §150.4 are the same person for the purpose of determining whether a person is eligible for a bona fide hedging position exemption under §150.3. The aggregate short position in the futures contract held by Company A and Company B represents a substitute for transactions to be taken at a later time in the physical marketing channel. The aggregate short position in the futures contract held by Company A and Company B is economically appropriate to the reduction of price risk because the aggregate short position in the CBOT Wheat futures contract held by Company A and Company B, equivalent to five million bushels of wheat, does not exceed the five million bushels of wheat that is owned by Company B. The price risk exposure for Company A and Company B results from a potential change in the value of that wheat.

32. Add appendix D to part 150 to read as follows:

Appendix D to Part 150 – Initial Position Limit Levels

Contract	Spot-Month	Single Month and All Months
Legacy Agricultural		
Chicago Board of Trade Corn (C)	600	53,500
Chicago Board of Trade Oats (O)	600	1,600
Chicago Board of Trade Soybeans (S)	600	26,900
Chicago Board of Trade Soybean Meal (SM)	720	9,000
Chicago Board of Trade Soybean Oil (SO)	540	11,900
Chicago Board of Trade Wheat (W)	600	16,200
ICE Futures U.S. Cotton No. 2 (CT)	300	8,800
Kansas City Board of Trade Hard Winter Wheat (KW)	600	6,500
Minneapolis Grain Exchange Hard Red Spring Wheat (MWE)	600	3,300
Other Agricultural		
Chicago Board of Trade Rough Rice (RR)	600	2,200
Chicago Mercantile Exchange Class III Milk	1500	3,400

Contract	Spot-Month	Single Month and All Months
(DA)		
Chicago Mercantile Exchange Feeder Cattle (FC)	300	3,000
Chicago Mercantile Exchange Lean Hog (LH)	950	9,400
Chicago Mercantile Exchange Live Cattle (LC)	450	12,900
ICE Futures U.S. Cocoa (CC)	1,000	7,100
ICE Futures U.S. Coffee C (KC)	500	7,100
ICE Futures U.S. FCOJ-A (OJ)	300	2,900
ICE Futures U.S. Sugar No. 11 (SB)	5,000	23,500
ICE Futures U.S. Sugar No. 16 (SF)	1,000	1,200
Energy		
New York Mercantile Exchange Henry Hub Natural Gas (NG)	1,000	149,600
New York Mercantile Exchange Light Sweet Crude Oil (CL)	3,000	109,200
New York Mercantile Exchange NY Harbor ULSD (HO)	1,000	16,100

Contract	Spot-Month	Single Month and All Months
New York Mercantile Exchange RBOB Gasoline (RB)	1,000	11,800
Metal		
Commodity Exchange, Inc. Copper (HG)	1,200	5,600
Commodity Exchange, Inc. Gold (GC)	3,000	21,500
Commodity Exchange, Inc. Silver (SI)	1,500	6,400
New York Mercantile Exchange Palladium (PA)	650	5,000
New York Mercantile Exchange Platinum (PL)	500	5,000

Issued in Washington, DC, on November 7, 2013, by the Commission.

Melissa D. Jurgens,

Secretary of the Commission.

NOTE: The following appendices will not appear in the Code of Federal Regulations.

Appendices to Position Limits for Derivatives – Commission Voting Summary and Statements of Commissioners

Appendix 1 – Commission Voting Summary

On this matter, Chairman Gensler and Commissioners Chilton and Wetjen voted in the affirmative. Commissioner O'Malia voted in the negative.

Appendix 2 – Statement of Chairman Gary Gensler

I support the proposed rule to establish position limits for physical commodity derivatives.

The CFTC does not set or regulate prices. The Commission is charged with promoting the integrity of the futures and swaps markets. The Commission is charged with protecting the public from fraud, manipulation and other abuses.

Since the Commodity Exchange Act passed in 1936, position limits have been a tool to curb or prevent excessive speculation that may burden interstate commerce.

For a fuller understanding of this long history, refer to the excellent testimony of our former General Counsel Dan Berkovitz from July of 2009 titled: "Position Limits and the Hedge Exemption, Brief Legislative History."

In the Dodd-Frank Act, Congress directed the Commission to impose limits on speculative positions in physical commodity futures and options contracts and economically equivalent swaps.

The CFTC finalized a rule in October 2011 that addressed Congress' direction to prevent any single trader from obtaining too large a share of the market to ensure that derivatives markets remain fair and competitive. Last fall, a federal court vacated the rule.

It is critically important, however, that these position limits be established as Congress required.

The agency has historically interpreted our obligations to promote market integrity to include ensuring that markets do not become too concentrated. When the CFTC set position limits in the past, it sought to ensure that the markets were made up of a broad group of participants with no one speculator having an outsized position. This promotes the integrity of the price discovery function in the market by limiting the size of any one speculator's footprint in the market.

Position limits further protect the markets and clearinghouses, as such limits diminish the possible burdens when any individual participant may need to sell or liquidate a position in times of individual stress.

Thus, position limits help to protect the markets both in times of clear skies and when there is a storm on the horizon.

With a strong proposal ready for the Commission's consideration today, we determined that the best path forward to expedite position limits implementation was to pursue the new rule and dismiss the appeal of the court's ruling, subject to the Commission's approval of this proposal.

Today's proposed rule is consistent with congressional intent. The rule would establish position limits in 28 referenced commodities in agricultural, energy and metals markets as part of a phased approach.

It would establish one position limits regime for the spot month and another for single-month and all-months-combined limits.

Spot-month limits would be set for futures contracts that can be physically settled, as well as those swaps and futures that can only be cash settled. We are seeking

additional comment on alternatives to a conditional spot-month limit exemption with regard to cash-settled contracts.

Single-month and all-months-combined limits, which the Commission currently sets only for certain agricultural contracts, would be reestablished in the energy and metals markets and be extended to swaps. These limits would be set using a formula that is consistent with that which the CFTC has used to set position limits for decades. The limits will be set based upon data on the total size of the swaps and futures market collected through the position reporting rules for futures, options on futures, and swaps.

Consistent with congressional direction, the rule also would allow for a bona fide hedging exemption for agricultural and exempt commodities. Also following congressional direction, there is a narrower exemption for swap dealers with regard to their use of futures and swaps to facilitate the bona fide hedging of their customers.

Today's proposed position limits rule builds on over four years of significant public input. In fact, this is the ninth public meeting during my tenure as Chairman to consider position limits.

We held three public meetings on this issue in the summer of 2009 and got a great deal of input from market participants and the broader public.

We also benefited from the more than 8,200 comments we received in response to the January 2010 proposed rulemaking to reestablish position limits in the energy markets.

We further benefited from input received from the public after a March 2010 meeting on the metals markets. In response to the January 2011 proposal, we received more than 15,100 comments.

Appendix 3 – Statement of Commissioner Bart Chilton

For two reasons, this is a significant day for me. I am reminded of that great Etta James song, *At Last*.

The first reason is that, *at last*, we are considering what I believe to be the signal rule of my tenure here at the Commission; I've been working on speculative position limits since 2008. The second reason today is noteworthy is that this will be my last Dodd-Frank meeting. Early this morning, I sent a letter to the President expressing my intent to leave the Agency in the near future. I've waited until now—today—to get this proposed rule out the door, and now—at last—with the process coming nearly full circle, I can leave. It's with incredible excitement and enthusiasm that I look forward to being able to move on to other endeavors.

With that, here is a bit of history on the position limits journey that has led us, and me, to this day. The early spring of 2008 was a peculiar time at the Commission. None of my current colleagues were here. I and my colleagues at that time watched Bear Stearns fail. We had watched commodity prices rise as investors sought diversified financial havens. When I asked Commission staff about the influence of speculation on prices, some said speculative positions couldn't impact prices. It didn't ring true, and as numerous independent studies have confirmed since, it was not true.

I began urging the Commission to implement speculative position limits under our then-existing authority. And I was, at that time, the only Commissioner to support position limits. Given the concerns, I urged Congress to mandate limits in legislation. A Senate bill was blocked on a cloture vote that summer, but late in the session, the House

actually passed legislation. Finally, in 2010, as part of the Dodd-Frank law, Congress mandated the Commission to implement position limits by early in 2011.

Within the Commission, I supported passing a rule that would have complied with the time-frame established by Congress—by any other name—federal law. A position limits rule was proposed in January of 2011 and finally approved in November.

In September 2012, literally days before limits were to be effective, a federal district court ruling tossed the rule out, claiming the CFTC had not sufficiently provided rationale for imposing the rule. We appealed and I urged us to address the concerns of the court by proposing and quickly passing another new and improved rule. I thought and hoped that we could move rapidly. After months of delay and deferral, it became clear: we could not.

But today—at last—more than three years since Dodd-Frank's passage, we are here to take it to the limits one more time.

Thankfully, we have it right in the text before us. The Commission staff has ultimately done an admirable job of devising a proposed regulation that should be unassailable in court, good for markets and good for consumers.

I thank everyone who has worked upon the rule: Steve Sherrod, Riva Adriance, Ajay Sutaria, Scott Mixon, Mary Connelly, and many others for their good work. In addition, I especially thank Elizabeth Ritter, my Chief of Staff, Nancy Doyle, and also Salman Banaei who has left the Agency for greener pastures. I thank them for their tireless efforts on the single most important, and perhaps to me the most frustrating, policy issue of my tenure with the Commission. I have had the true honor of working with Elizabeth since prior to my confirmation. I would be remiss if I did not reiterate

here what I have often said; nowhere do I believe there is a brighter, smarter, more knowledgeable and hard-working derivatives counsel. She has served the public and me phenomenally well. Thank you, Elizabeth.

And finally to my colleagues, past and present, my respect to those whom we have been unable to persuade to vote with us on this issue, and my thanks to those who will vote in support of this needed and mandated rule. *At last!*

Thank you.

Appendix 4 – Dissenting Statement of Commissioner Scott D. O'Malia

I respectfully dissent from the Commission's decision to approve the Notice of Proposed Rulemaking for Position Limits for Derivatives. I have a number of serious concerns with the position limits proposed rule and its interpretation of section 4a(a) of the Commodity Exchange Act ("CEA" or "Act").[1] Regrettably, this proposal continues to chip away at the commercial and business operations of end-users and the vital hedging function of the futures and swaps markets.

I cannot support the position limits proposed rule that is before the Commission today because the proposal: (1) fails to utilize current, forward-looking data and other empirical evidence as a justification for position limits; (2) fails to provide enough flexibility for commercial end-users to engage in necessary hedging activities; and (3) fails to establish a useful process for end-users to seek hedging exemptions.

We Are the Experts, But Where's the Evidence?

Recently, in connection with the Commission's vote to dismiss its appeal[2] of the vacated 2011 position limits rule,[3] I reiterated that the federal district court[4] had

[1] 7 U.S.C. 6a(a).
[2] *ISDA & SIFMA v. CFTC*, No. 12-5362 (D.C. Cir.).

instructed the Commission to go back to the drawing board and do its homework.[5] As I have consistently stated, the Commission must perform a rigorous and objective fact-based analysis in order to determine whether position limits will effectively prevent or deter excessive speculation.[6] Not only that, but the Commission must also, in establishing any limits, ensure that there is sufficient market liquidity for hedgers and prevent disruption of the price discovery function of the underlying market. Unfortunately, the position limits rule that is being proposed today is not based upon a careful, disciplined review of market dynamics or the new data collected under our expanded oversight responsibilities provided for by the Dodd-Frank Act.[7]

In its second attempt at establishing a broad position limit regime that is in accordance with the statutory language amended by Dodd-Frank, the Commission relies on a new legal strategy—but not new data—in order to circumvent the spirit of the district court's decision. Surprisingly, the Commission now accepts that the statutory language in CEA section 4a(a)(1)[8] is ambiguous and that there is not a clear mandate from Congress to set position limits, contrary to the arguments made by the Commission both in court and in the vacated rule. Notwithstanding that concession, the proposed rule now hides behind *Chevron* deference and invokes the Commission's "experience and expertise" in order to justify setting position limits without performing an ex ante analysis using current market data.[9]

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[3] 76 Fed. Reg. 71626 (Nov. 18, 2011).
[4] *Int'l Swaps & Derivatives Ass'n v. CFTC*, 887 F. Supp. 2d 259, 280-82 (D.D.C. 2012).
[5] http://www.cftc.gov/PressRoom/SpeechesTestimony/omaliastatement102913.
[6] http://www.cftc.gov/PressRoom/SpeechesTestimony/omaliadissentstatement111512.
[7] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).
[8] 7 U.S.C. 6a(a)(1).
[9] NPRM pp. 12-14, 24, 32, 171.

I am troubled that the proposal uses only two examples from the past—one of them as far back as the 1970s—to cobble together a weak, after-the-fact justification that position limits would have prevented market disruption. This is glaringly insufficient. Instead, the Commission should have taken the time to analyze the new data, especially from the swaps market, that has been collected under the Dodd-Frank Act. It is especially troubling that the large trader data being reported under Part 20 of Commission regulations[10] is still unreliable and unsuitable for setting position limit levels, almost two full years after entities began reporting data, and that we are forced to resort to using data from 2011 and 2012 as a poor and inexact substitute.

Today, the Commission proposes to set position limits for the futures and swaps markets *in the future*, not the past. I fail to see how we can be "experts" if we do not have the data to back us up. I fear that this reliance on a new legal strategy, instead of evidence-based standards, does little to affirm the Commission's self-proclaimed "expertise" and could result in another long and costly court challenge that will strain our limited resources.

Preserving Flexibility for Commercial End-Users

I am also concerned that the position limits proposed rule may not preserve enough flexibility for commercial end-users to hedge risks inherent in their business operations. Hedging is the foundation of our markets, and the intent of the Dodd-Frank Act was not to place excessive and unnecessary new regulatory burdens on end-users and make it more complicated and more costly to undertake risk management. That was strongly

[10] 17 C.F.R. part 20.

underlined in the letter sent to the Commission by Senators Dodd and Lincoln in June 2010.[11]

Regrettably, the Commission's rules implementing Dodd-Frank have not adhered to that directive. This position limits proposal is just the latest in this disturbing trend of narrowly interpreting the statute to foreclose viable risk management functions that did not contribute to the financial crisis. This trend is nowhere more apparent than in how narrowly the proposal defines the concept of bona fide hedging.

The position limits proposed rule does away with Commission regulation 1.3(z),[12] which has been in effect since the 1970s, and sets forth new regulations that narrow the bona fide hedging definition, in particular the treatment of anticipatory hedging. This is despite the fact that the vacated position limits rule explicitly recognized certain anticipatory hedging transactions as falling within the statutory definition of bona fide hedging and consistent with the purposes of section 4a of the Act, and provided exemptions for such transactions given the condition that the trader was "reasonably certain" of engaging in the anticipated activity. In this proposal, based on an unsatisfactory "further review," the Commission has changed its mind and has scaled back exemptions for anticipatory hedging. In all, the Commission has rejected half of the common hedging scenarios described by a working group of end-users in their petition for exemption.

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[11] Letter from Chairman Christopher Dodd, Committee on Banking, Housing, and Urban Affairs, United States Senate, and Chairman Blanche Lincoln, Committee on Agriculture, Nutrition, and Forestry, United States Senate, to Chairman Barney Frank, Financial Services Committee, United States House of Representatives, and Chairman Colin Peterson, Committee on Agriculture, United States House of Representatives (June 30, 2010).

[12] 17 CFR 1.3(z).

I question whether the Commission has fulfilled Congress' intent to protect end-users by proposing a new position limits rule that articulates a far too narrow conception of bona fide hedging and does not reflect the realities of end-users' commercial and business operations.

A Workable, Practical Process for Non-Enumerated Hedging Exemptions

I am especially troubled by the proposed rule's elimination of Commission regulations 1.3(z)(3) and 1.47,[13] which is the framework for market participants to seek a non-enumerated hedging exemption. I question whether eliminating a workable, practical process that has been outlined in Commission regulations for decades will make it more difficult for end-users to seek exemptions for legitimate hedging transactions and will cause unnecessary delay and interference with business operations.

Aggregation Proposed Rule

While I believe that today's aggregation proposed rule is more responsive than the vacated rule to the realities that market participants face in their utilization of the futures and swaps markets, some important concerns still remain.

First, the aggregation standards in the proposal present significant technology challenges for compliance, especially across affiliates. I would support a phase-in period to meet those challenges.

Second, I am concerned that there is insufficient consideration and flexibility in the ownership tiers that are used as a proxy for control. I would be interested in reviewing comments on pro rata aggregation, banding/tiering of ownership interest instead of full aggregation, and other issues with beneficial ownership. Further, I

[13] 17 CFR 1.3(z)(3) and 1.47.

question whether the possible exemption for ownership in excess of 50% is of use to any market participants, given the additional conditions that are imposed.

Cost-Benefit Considerations

It is imperative that market participants carefully review the new position limits and aggregation proposed rules and provide comments. I especially encourage market participants to include any comments on the cost impact of the proposed position limits. I would also like to receive input from market participants about the cost of changes to their operations that were undertaken in order to prepare for compliance with the previous position limit rules, before those rules were vacated by the court. While the Commission failed to give enough weight to these consequences, I intend to carefully consider the comments and the critical information they provide in evaluating any draft final rule put before the Commission.

Conclusion

It is rare to get a second chance to do things right. I am disappointed by the Commission's approach today because the Commission has not taken advantage of the opportunity for a second chance presented by the district court decision to vacate the 2011 position limits rule. The Commission has failed in its duty as a responsible market regulator by not taking the time to gather the evidence and establish sound justifications for position limits ex ante that are based on data. Because of this failure, as well as the narrowing of the bona fide hedging definition and the elimination of the existing process for end-users to seek non-enumerated hedging exemptions, I cannot support this proposal.

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