The CFTC's Position Limits on Derivatives Proposal: **Six Things To Know**

At an open meeting on January 30, 2020, the Commodity Futures Trading Commission ("CFTC") voted 3–2 to approve a proposed rule that would impose federal position limits on derivatives. The proposed rule, if finalized, would prevent excessive speculation while allowing bona fide hedgers in agricultural, energy, metals, and other commodities markets to hedge risk in certain, enumerated circumstances.

1 The proposal is the latest step in the CFTC's years-long effort to implement position limits.

The Dodd–Frank Act, passed in 2010, amended Section 4a of the Commodities Exchange Act to require the CFTC to establish position limits as necessary to prevent "the burdens associated with excessive speculation causing sudden or unreasonable fluctuations or unwarranted changes in price." In 2011, the CFTC adopted a rule imposing position limits regulations, but in 2012, the U.S. District Court for the District of Columbia vacated the rule on *Chevron* grounds (referring to the doctrine of judicial deference given to administrative actions) because the CFTC had not made a formal finding that position limits are necessary to prevent burdens on interstate commerce, which the court deemed a necessary predicate to the rule's promulgation. The CFTC issued further position limits proposals in December 2013 and June 2016 and reissued the latter proposal in December 2016. None became a final rule. CFTC Chairman Heath Tarbert has consistently maintained that his administration would finally pass a position limits rule to fulfill one of the last remaining mandates of the Dodd–Frank Act. Chairman Tarbert said of the proposal during the open meeting that the Commissioners "want to get it done, we want to get it done right . . . and [ensure] it's upheld by the courts."

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2 The proposal would impose position limits on 25 enumerated physically settled commodities and over 400 related non-enumerated commodities.

Expanding beyond the 9 legacy agricultural commodity futures contracts already subject to federal position limits, the proposal enumerates 25 "core referenced futures contracts" that would also be subject to federal position limits. These commodities include 16 agricultural futures, 5 metals futures, and 4 energy futures. These proposed position limits would also cover other futures and options that are "directly or indirectly linked" to one of the 25 enumerated futures contracts. A CFTC Division of Market Oversight ("DMO") representative stated during the open Commission meeting that approximately 400 contracts would fall in this category. Swaps that are economically equivalent to either of these categories would also be subject to position limits.

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3 The proposal creates an expansive list of self-effectuating hedge exemptions that will eliminate or roll back certain features of current law.

The enumerated core reference futures contracts would qualify for an expansive list of self-effectuating exemptions from CFTC-imposed limits. Traders whose wish to use one of the enumerated exemptions in these contracts would need only to request and obtain the exemption from an exchange in order to begin hedging. This would eliminate the obligation to submit Form 204s, which are monthly reports of cash positions that traders in agricultural products must submit to evidence underlying bona fide hedging and justify position limit overages. It would also eliminate the cash position reporting sections in Form 304, which contains similar information for trading in cotton products. DMO Staff indicated that such forms are often a source of redundant data, making their submission unnecessary.

4 Requests to hedge non-enumerated contracts would be subject to a new, streamlined approval process.

Market participants seeking to hedge a futures contract in a manner not enumerated in the proposed rule can avail themselves of a "streamlined" process for approval. A participant can submit an application for exemption directly to the relevant exchange. If the exchange grants the approval, it will notify the participant and the CFTC simultaneously. Unless the CFTC reverses the exchange's decision within 10 days (or in certain narrow circumstances, 2 days), the participant would receive the requested exemption for the hedging limits set by the exchange and by the CFTC. The CFTC's reversal of an exchange's decision would require formal action by the full Commission and would not be delegable to CFTC staff. If the CFTC ultimately decides not to grant an exemption, the participant would have a commercially reasonable amount of time to reverse the hedging position before incurring liability, so long as it applied for the exemption in good faith. Of the streamlined process Chairman Tarbert said, "Given our expanded definition of bona fide hedging, I anticipate that it would be a rare case that a market participant finds its legitimate hedging needs are not already covered in the list of enumerated exemptions. Still, this process would provide flexibility and legal certainty, without excessive red tape."

5 The two dissenting Commissioners voiced concerns about the proposal's legal grounding.

The court that struck down the 2011 position limits rule disagreed with the CFTC's argument that the Dodd–Frank amendments to the CEA unambiguously mandated the CFTC to impose position limits. In the open meeting this week, attorneys from the CFTC's Office of General Counsel ("OGC") made the case that the proposal can withstand the legal challenges that proved fatal to the 2011 rule. Under their interpretation of the Dodd–Frank amendments, the CFTC must make a formal finding that imposing position limits is necessary to diminish, eliminate, or prevent burdens on interstate commerce before it can have the power to impose limits. Once it makes this finding, the OGC argued, the statutory ambiguity that sank the 2011 rule in court will be resolved, and the CFTC's position limits rule will be entitled to *Chevron* deference.

The two dissenting Commissioners were not convinced. Commissioner Dan Berkowitz argued that the CFTC may prophylactically impose restrictions on hedging without any predicate finding of necessity — in his view, a statutory interpretation more faithful to the CEA. According to Berkovitz, the proposal is vulnerable to a challenge that it is arbitrary and capricious under the Administrative Procedures Act. Commissioner Rostin Behnam agreed that the antecedent necessity finding is not supported by the statute. He also expressed the opinion that the proposal's significant delegation of limit-setting from the CFTC to commodities exchanges runs counter to the congressional intent behind Section 4a.

6 Be certain to provide fulsome and timely comments to the proposed rule.

The Chairman has urged all market participants to submit comments on this proposal to indicate what parts of the rule would work well and what parts should be revisited. The Commissioners specifically encouraged comments on a potential phase-in period, the list of enumerated core reference futures contracts, the CFTC's delegation of review authority to the exchanges, and the clarity the proposal provides market participants. The proposal's comment window will close on **April 29, 2020.** The Futures and Derivatives team at Covington, with its experience and expertise in these markets and before the CFTC, is well-positioned to assist clients in drafting and submitting comments, as well as engaging the Commission on the substance of this proposed rule as it applies to each participant's unique circumstances.

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