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CFTC Proposes Position Limits for Natural Gas, Crude Oil, Heating Oil, and Gasoline Futures Contracts

On January 14, 2010, the Commodity Futures Trading Commission (CFTC) issued a notice of proposed rulemaking¹ in which it proposed to adopt position limits² for the following four New York Mercantile Exchange (NYMEX) futures contracts: (1) the Henry Hub natural gas contract (NG); (2) the Light Sweet crude oil contract (CL); (3) the New York Harbor No. 2 heating oil contract (HO); and (4) the New York Harbor gasoline blendstock (RBOB) contract (collectively, Referenced Energy Contracts). For each of the Referenced Energy Contracts, the CFTC proposes to establish all-months-combined (AMC), single (non-spot) month, and spot-month³ position limits that would apply to a trader's aggregate holdings in that contract and economically similar⁴ futures and options contracts. The Position Limits NOPR also proposes to adopt exemptions for *bona fide* hedging transactions, certain swap dealer⁵ risk management transactions, and for certain risk-adjusted option positions. Comments on the Position Limits NOPR will be due April 26, 2010 (*i.e.*, 90 days after publication in the *Federal Register*).

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I. Background

A. Federal Position Limit Regulation

Section 4a(a) of the Commodity Exchange Act of 1936 (CEA) gives the CFTC the authority to establish position limits “[f]or the purpose of diminishing, eliminating, or preventing” the burden of “excessive speculation,” which Congress has defined as “sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity”⁶ The CFTC’s jurisdiction to establish position limits was originally limited to specifically enumerated agricultural commodities, but Congress subsequently expanded it to cover contracts for any commodity traded on a DCM,⁷ including the Referenced Energy Contracts, and to SPDCs listed on ECMs (ECM-SPDCs),⁸ such as the ICE Henry Financial LD1 Fixed Price natural gas contract.⁹



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The CEA also grants DCMs and ECM-SPDCs certain self-regulatory responsibilities, provided that they comply with certain “core principles,”¹⁰ including the requirement to maintain position and accountability limits (Position Limits Core Principle). Section 4a(e) of the CEA gives the CFTC the authority to directly enforce the speculative position limits set by DCMs and ECM-SPDCs (collectively, Reporting Markets).

B. Current CFTC and Exchange-Set Position Limits on Referenced Energy Contracts

The CFTC’s regulations do not currently specify position limits for the Referenced Energy Contracts, but each of these contracts is subject to position accountability rules and position limits established by NYMEX and ICE. The CFTC’s regulations provide guidance to DCMs, such as NYMEX, regarding compliance with the Position Limits Core Principle, which is based on the CFTC’s position limit regulations applicable to other types of commodities.¹¹ Specifically, the CFTC’s existing regulations provide that Reporting Markets may set AMC and single non-spot month position limits to be no greater than 10% of the average, month-end open interest¹² (which includes both futures contract positions and “futures-equivalent” option positions)¹³ for the most recent calendar year up to an open interest of 25,000 contracts, with a marginal increase of 2.5% thereafter. Alternatively, position limits may be based on the position sizes customarily held by speculative traders on that market.¹⁴ The spot-month position limit for physical delivery contracts must be no greater than one-quarter of the estimated spot month deliverable supply,¹⁵ while the spot-month position limit for cash-settled contracts must not be greater than necessary to minimize the potential for manipulation of the contract market or the market for the underlying commodity.¹⁶

II. Overview of Positions Limits NOPR

As described in the Position Limits NOPR, the proposed regulations would implement an integrated speculative position limit framework for exchange-listed natural gas, crude oil, heating oil, and gasoline futures and option contracts. The proposed position limits would be in addition to, rather than a substitute for, the position limits established by the Reporting Markets. Based on data received through the CFTC’s large trader reporting system, the CFTC estimates that possibly ten entities, including traders holding positions pursuant to exchange-approved *bona fide* hedge exemptions, would be affected by the proposed position limits.

A. Proposed Aggregate AMC and Single Non-Spot Month Position Limits

The proposed AMC and single non-spot month position limits would limit positions to a specific percentage of overall trading activity as represented by open interest. The AMC speculative position limit would be 10% of the first 25,000 contracts of open interest and 2.5% of open interest beyond 25,000 contracts. The single non-spot month position limit would be set at two-thirds of the AMC position limit. These proposed position limits would apply to aggregate positions (*i.e.*, net long or net short) in futures and options combined, plus mini-sized contracts in the same commodity, aggregated across all Reporting Markets.¹⁷

In setting the AMC and single non-spot month position limits, the CFTC explains that it would first identify all the Referenced Energy Contracts that are “contracts of the same class”—*i.e.*, all futures contracts



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(including options contracts on a futures-equivalent basis) listed on a single Reporting Market that are based on the same commodity and delivered in the same manner (cash settled or physically delivered) at the same location—and it would then calculate each class’s average combined futures and delta-adjusted option month-end open interest for all months listed on a Reporting Market during the most recent calendar year as the first reference point (“class single-exchange gross open interest value”).¹⁸ Once a class single-exchange final open interest value is determined, the CFTC would sum this value for all related classes on and across all Reporting Markets to arrive at an “aggregated market open interest value.” The position limit would then be calculated based on this value using the formula above (10% of open interest up to 25,000 contracts, and then 2.5% thereafter).

The CFTC also proposes to establish “single-exchange” position limits, *i.e.*, separate AMC and single non-spot month position limits for each Reporting Market. The AMC position limit would be equal to the lower of the aggregate position limit for a Referenced Energy Contract or 30% of a class’s single-exchange final open interest value. The single exchange, non-spot month limit would be equal to two-thirds of that value—or as much as 20%—of the total open interest on that Reporting Market. For a new Reporting Market, the CFTC proposes a *de minimis* AMC position limit equal to the greater of 5,000 contracts or 1% of all open interest in a Referenced Energy Contract.

B. Proposed Spot-Month Position Limits

The proposed spot-month position limits are a function of the estimated deliverable supply for physically delivered contracts and are designed to prevent traders with sufficiently large positions from distorting the price of the deliverable commodity. For physically delivered contracts, the CFTC proposes to set spot-month position limit at 25% of the estimated deliverable supply.¹⁹ For contracts that cash settle based on the prices of physically delivered contracts, the CFTC proposes a conditional-spot-month position limit that would likewise be equal to 25% of deliverable supply. For traders that do not hold any physically delivered contracts in the spot month, however, the conditional-spot-month position limit for the cash-settled contract would be equal to five times the spot-month position limit for the physically delivered contract.²⁰

The proposed spot-month position limits would apply only to the same class of contracts. As a result, the CFTC would establish separate spot-month position limits for cash-settled and physically delivered contracts.²¹ In addition, contracts for the same month that expire on different days would not be in the same class and therefore would have separate spot-month position limits.²²

C. Aggregation Rules

The CFTC’s proposed position limits would apply to all positions in accounts in which any person, directly or indirectly, has an ownership or equity interest of 10% or greater or otherwise controls trading in that account.²³ The CFTC proposes a limited exemption for positions in pools in which a trader is a limited partner, shareholder, or similar person that has an ownership or equity interest of less than 25%, unless the trader in fact controls trading that is done by the pool.²⁴



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III. Exemptions

A. *Bona Fide* Hedging Transactions

The CFTC proposes to adopt a *bona fide* hedging exemption for traders hedging commercial risks (e.g., airlines purchasing futures contracts to hedge the cost of fuel) to the extent of their demonstrated needs.²⁵ To obtain this exemption, traders must apply to the applicable Reporting Market. The Position Limits NOPR sets forth the procedures for doing so, as well as proposed additional reporting requirements.²⁶ A trader holding *bona fide* hedging positions greater than the proposed position limits would not be able to simultaneously hold a speculative position.²⁷

B. Swap Dealer Risk Management Transactions

The CFTC also proposes to exempt certain swap dealer risk management transactions to permit swap dealers to offset customer initiated swap positions held outside the spot month. Specifically, the swap dealer exemption would be limited to twice the otherwise applicable AMC or single non-spot month position limit.²⁸ Swap dealers holding large positions pursuant to the proposed swap dealer exemption would be unable to also take on positions as speculators. To obtain this exemption, the swap dealer would have to file a completed CFTC Form 40, an initial application, an annual update to certify that the person remains a swap dealer,²⁹ and file a completed Form 404 Part C each month with the CFTC and with any Reporting Market on which the swap dealer's Referenced Energy Contract positions are listed.³⁰

C. Exemption for Certain Delta-Adjusted Option Positions

Finally, the CFTC proposes to exempt persons whose positions would have exceeded the applicable speculative position limit for a Referenced Energy Contract when adjusted by the previous day's risk factors (i.e., option deltas), but that would not exceed such a limit when positions are calculated using an appropriate contemporaneous risk factor.³¹

¹ Notice of Proposed Rulemaking, *Federal Speculative Positions Limits for Referenced Energy Contracts and Associated Regulations*, 75 Fed. Reg. 4,144 (Jan. 26, 2010) (Position Limits NOPR) (to be codified at 17 C.F.R. Pt. 151).

² The CFTC's position limits prohibit a person from holding or controlling positions in a given contract, or class of contracts, that exceed a specific number of contracts. Proposed Regulation 17 C.F.R. § 151.2. *See also* 17 C.F.R. § 150.2 (establishing position limits for certain agricultural commodities).

³ The CFTC proposes to define the spot-month contract as the futures contract that is the "next to expire during that period of time beginning at 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 registered entity." Proposed Regulation 17 C.F.R. § 151.1. The CFTC notes that, in practice, the spot month is normally three days in duration—the expiration date and the two immediately preceding trading days.

⁴ As discussed further below, each of the four types of Referenced Energy Contracts also includes any economically similar contract that is exclusively or partially based on the Referenced Energy Contracts and deliverable at the same location as that contract (specifically, Henry Hub, Louisiana for natural gas; Cushing, Oklahoma for light sweet crude oil; and New York Harbor for both No. 2 heating oil and RBOB), whether that contract is listed on a Designated Contract Market (DCM) such as NYMEX



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or is a “significant price discovery contract” (SPDC) listed on an exempt commercial market (ECM) such as the IntercontinentalExchange Inc. (ICE). The proposed rules would not, however, apply to “basis contracts” (*i.e.*, contracts that are cash settled based on the difference in price of the same commodity at different delivery points) and diversified commodity index futures (*i.e.*, commodity indexes that are comprised of contracts in energy as well as non-energy commodities such as the S&P/Goldman Sachs Commodity Index or the Dow Jones–UBS Commodity Index.) Proposed Regulation 17 C.F.R. § 151.1.

⁵ Proposed regulation 151.1 would also define “swap dealer” to mean “any person who, as a significant part of its business, holds itself out as a dealer in swaps, makes a market in swaps, regularly engages in the purchase of swaps and their resale to customers in the ordinary course of a business, or engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.” Proposed Regulation 17 C.F.R. § 151.1.

⁶ 7 U.S.C. § 6a(a).

⁷ Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2299-30 (1982).

⁸ Food, Conservation and Energy Act of 2008, Pub. L. No. 110-246, 122 Stat. 1624 (2008) (CFTC Reauthorization Act).

⁹ To date, ICE’s Henry Financial LD1 Fixed Price natural gas contract is the first and only ECM contract to have been determined by the Commission to be a SPDC under section 2(h)(7) of the Act. *See Order Finding That the ICE Henry Financial LD1 Fixed Price Contract Traded on the IntercontinentalExchange Inc., Performs a Significant Price Discovery Function*, 74 Fed. Reg. 37,988 (July 30, 2009). In October 2009, the CFTC issued notices of its intent to review whether over a dozen financial natural gas and power contracts traded on ICE are SPDCs, although the Commission has not made any determinations regarding these contracts. *See generally CFTC to Review Whether Certain ICE Contracts Are “Significant Price Discovery Contracts”* <http://www.kslaw.com/Library/publication/ca101609b.pdf>.

¹⁰ *See* CEA § 5(d), 7 U.S.C. § 7(d) (core principles for DCMs); CEA § 2(h)(7), 7 U.S.C. § 2h(7)(C) (core principles for ECM-SPDCs).

¹¹ *See* 17 C.F.R. Pt. 38, App. B (referencing 17 C.F.R. § 150.5(c) as source of guidance for compliance with the Position Limits Core Principle). *See also* 17 C.F.R. Pt. 36, App. B (providing guidance to ECMs regarding compliance with the Position Limits Core Principle).

¹² Open interest is calculated based on the number of “open contracts,” *i.e.*, is the total number of futures contracts for a given commodity and delivery month that have been entered into but “have not been fulfilled by delivery nor offset by other contracts of sale or purchase in the same commodity and delivery month.” 17 C.F.R. § 1.3(t). Each open contract has a buyer and a seller, but for calculation of open interest, only one side of the contract is counted. *See* NYMEX Glossary, *available at*: <http://www.cmegroup.com/education/glossary.html>.

¹³ Under the CFTC regulations, position limits are denominated in futures contract “units.” Option contracts are converted into “futures-equivalent” positions using an option “delta.” 17 C.F.R. § 150.1(f). Option “delta” is a measure of the risk, or sensitivity, of the option price to changes in the price of the underlying futures contract or security. The CFTC requires Reporting Markets to publish option deltas, for each type of option (*i.e.*, puts and calls), strike price, and expiration date, on a daily basis. 17 C.F.R. § 16.01(a)(1).

¹⁴ 17 C.F.R. § 150.5(c)(2).

¹⁵ 17 C.F.R. § 150.5(c)(1). A physically delivered or physically settled contract is one where seller has an obligation to deliver (and the buyer has an obligation to take and pay for) a specified quantity of the underlying commodity at a specified location. For example, the NG contract requires the seller to deliver 10,000 million British thermal units of natural gas to Henry Hub, Louisiana, while the CL contract requires the seller to deliver 1,000 U.S. barrels of light sweet crude oil to Cushing, Oklahoma.

¹⁶ A cash-settled contract does not include any physical delivery obligation and is instead settled through cash payments based on the difference between the initial transaction price and the contract’s settlement price upon expiration.



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¹⁷ The CFTC estimates that the AMC and single non-spot month position limits would be as follows: (1) for the CL contract, 98,100 and 65,400 contracts, respectively; (2) for the RBOB contract, 9,000 and 6,000 contracts, respectively; (3) for the HO contract, 10,100 and 6,800 contracts, respectively; and (4) for the NG contract, 132,700 and 88,500 contracts, respectively.

¹⁸ The CFTC's proposed regulations would subtract the open interest generated from "spread contracts" from the "class single-exchange gross open interest value" to arrive at a "class single-exchange final open interest value." "Spread contracts" include calendar spread contracts (*i.e.*, contracts that are settled based on the difference between the settlement prices in one expiring month of the contract and another month's settlement price for the same contract such as the NYMEX Crude Oil Calendar Spread Financially Settled Option Contract) and inter-commodity spread contracts (*e.g.*, the NYMEX heating oil crack spread swap futures (HK) contract, which represents the price difference between two Referenced Energy Contracts, the NYMEX New York Harbor No. 2 heating oil futures settlement price minus the NYMEX Light Sweet crude oil futures settlement price). Although spread contracts are excluded from these open interest calculations, they are nevertheless Referenced Energy Contracts and will count for purposes of determining a trader's compliance with the proposed single-month position limits.

¹⁹ Proposed Regulation 17 C.F.R. § 151.2(a)(1). The proposed regulations would require an exchange to provide the CFTC with an estimate of deliverable supply each year. Proposed Regulation 17 C.F.R. § 151.2(d).

²⁰ Proposed Regulation 17 C.F.R. § 152.(a)(2). To qualify for the increased conditional-spot-month position limit for cash-settled contracts, the trader would also have to file a completed CFTC Form 40 and Part A of new CFTC Form 404, which requires detailed information on the trader's spot and forward positions in the relevant Referenced Energy Contract, the underlying physical commodity, swaps that are priced in relation to the Referenced Energy Contract and the underlying commodity, and other physical and financial contracts related to the trader's positions held pursuant to the conditional-spot-month position limit. Proposed Regulation 17 C.F.R. § 20.00.

²¹ Proposed Regulation 17 C.F.R. § 151.2(a).

²² The CFTC explains that it defined classes of contracts in this narrower manner during the spot month to prohibit the netting of spot-month contracts that expire on different days for the purpose of applying the proposed spot-month position limits. For example, a trader that is 4,000 contracts long in a cash-settled last trading day contract, and 4,000 contracts short in a cash-settled contract that expires one day earlier (*i.e.*, the "penultimate" contract) on the same Reporting Market would be subject to spot-month position limits for each contract and would not be deemed to be holding a flat position. The trader would, however, be permitted to net these positions for the purposes of compliance with AMC and single non-spot month position limits.

²³ The CFTC would also treat positions held by two or more persons acting pursuant to an express or implied agreement or understanding the same as if the positions were held by, or the accounts controlled by, a single person. Proposed Regulation 17 C.F.R. § 151.4(a).

²⁴ Proposed Regulation 17 C.F.R. § 151.4(b).

²⁵ Proposed Regulation 17 C.F.R. § 151.3(a)(1).

²⁶ A person holding this exemption would be required to file a completed CFTC Form 40 and Part B of new CFTC Form 404 that collects information regarding trading activities and positions in the commodity underlying the Referenced Energy Contract. Proposed Regulation 17 C.F.R. § 20.01.

²⁷ Specifically, traders holding positions pursuant to a *bona fide* hedge exemption would generally be prohibited from also trading speculatively. If *bona fide* hedging positions outside the spot month exceed twice an otherwise applicable AMC or single-month position limit, then such traders would also be prohibited from holding positions as swap dealers. In contrast, however, traders holding positions in the spot-month pursuant to a *bona fide* hedge exemption would not be prohibited from holding positions speculatively outside the spot month. Proposed Regulation 17 C.F.R. § 151.3(a)(1).

²⁸ Proposed Regulation 17 C.F.R. § 151.3(a)(2).

²⁹ Proposed Regulation 17 C.F.R. § 1.45.



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³⁰ The monthly report must state, for each day, swap positions based upon the commodity underlying the Referenced Energy Contracts that are held in proprietary and customer accounts and a summary of dealing and trading activity in swaps based upon the commodity underlying the Referenced Energy Contracts. In addition, the swap dealer would have to file a supplemental report whenever it establishes a larger position in Referenced Energy Contracts than previously reported. Proposed Regulation 17 C.F.R. § 20.02.

³¹ Proposed Regulation 17 C.F.R. § 151.3(a)(3).

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