

ISDA and SIFMA Attack Position Limits in First Challenge to CFTC Rulemaking Under the Dodd-Frank Act

December 7, 2011

At its open meeting on Tuesday October 19, 2011 the Commodity Futures Trading Commission (the CFTC) approved final rules (the Final Position Limits Rules) establishing position limits for 28 enumerated futures contracts,¹ options on such contracts and economically equivalent swaps and swaptions (so-called Referenced Contracts) under Section 4a(a) of the Commodity Exchange Act (the CEA), as amended by Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). The Final Position Limits Rules were published in the Federal Register on November 18, 2011, and are available [here](#).

On December 2, 2011, the International Swaps and Derivatives Association (ISDA) and the Securities Industry and Financial Markets Association (SIFMA) filed a joint lawsuit against the CFTC in the U.S. District Court for the District of Columbia challenging the Final Position Limits Rules (the Position Limits Lawsuit). A press release discussing the Position Limits Lawsuit and a link to the complaint filed by ISDA and SIFMA are available [here](#).

The Final Position Limits Rules

With certain exceptions for changes made in response to public comments, the Final Position Limits Rules are substantially similar to the CFTC's proposed rules for position limits issued in January 2011. As contemplated by the CFTC's proposed rules, the Final Position Limits Rules will take effect in two phases.

Existing Part 150 of the CFTC's regulations currently imposes aggregate position limits on nine agricultural futures contracts. Until phase one of the Final Position Limits Rules takes effect, market participants must continue to comply with these limits, including the aggregation requirements applicable thereto and the exemption therefrom for bona fide hedging transactions. Once phase one of the Final Position Limits Rules takes effect, the CFTC will revoke Part 150 of its regulations, and the CFTC's existing position limits regime will no longer apply.²

Phase One

The first phase of the Final Position Limits Rules will include CFTC imposition of the existing exchange-imposed spot-month limits for Referenced Contracts and aggregate (*i.e.*, all months combined) limits for nine "legacy" agricultural Referenced Contracts.

¹ These include agricultural futures contracts currently subject to CFTC position limits, as well as futures contracts on exempt commodities, including certain metals and energy futures contracts.

² Also note that exchanges currently impose spot-month, single month and aggregate position and accountability limits on certain futures contracts. Market participants must continue to comply with these limits in addition to existing and new CFTC position limits. Under the Final Position Limits Rules, exchanges and new swap execution facilities on which Reference Contracts trade must establish position limits that are *at least as strict* as the CFTC's position limits.

As was the case under the CFTC's proposed rule, for Referenced Contracts (other than NYMEX Henry Hub Natural Gas Contracts) in the spot month, traders may have up to the limit in physical positions *and* up to the limit in cash positions. For NYMEX Henry Hub Natural Gas Contracts, traders may have up to the existing exchange-imposed limit in physical contracts and up to five times that limit in aggregate positions (*i.e.*, physical positions plus cash positions).

The aggregate limits for the nine legacy agricultural Referenced Contracts will be set at the levels in the Chicago Board of Trade's petition submitted to the CFTC on April 6, 2010, which were based on 2009 open interest data for futures and options contracts. While these levels are seen as an improvement over the "legacy limits" in the CFTC's proposed rule, which were based on 2004 open interest data for futures and options contracts, the levels do not fully address commenters' concerns because they do not account for open interest in economically equivalent swaps and swaptions.

The phase one position limits will take effect 60 days after the effectiveness of the CFTC's final rules further defining "swap" and "security-based swap." At this time, it is not expected that those rules will take effect until the beginning of 2012 at the earliest. Accordingly, the phase one position limits are not expected to take effect until the second quarter of 2012. Beginning in the second calendar year thereafter, spot-month limits for Referenced Contracts will be reset annually by CFTC order at 25% of deliverable supply based on information provided by the exchanges to the CFTC.

Phase Two

The second phase of the CFTC's position limits will include CFTC-established spot-month and aggregate limits for all Referenced Contracts.

Beginning in the second calendar year after the spot-month limits in phase one take effect, spot-month limits for Referenced Contracts will be set by CFTC order at 25% of deliverable supply based on information provided by the exchanges to the CFTC. The spot-month limits will be reset every two years for metal and energy Referenced Contracts and annually for agricultural Referenced Contracts. Accordingly, these spot-month limits are not expected to take effect until the second quarter of 2013.

The aggregate limits to be established in phase two will be based on open interest for futures contracts and cleared and uncleared swaps and will be established using the 10%/2.5% formula in the proposed rules (*i.e.*, 10% of open interest for the first 25,000 contracts of open interest and 2.5% of all contracts of open interest thereafter). Unlike the spot-month position limits in the Final Position Limits Rules and the aggregate limits in the CFTC's proposed position limit rules, the Final Position Limits Rules allow market participants to net their positions in futures with their positions in swaps for purposes of the CFTC's aggregate position limits.

The aggregate limits in phase two will take effect by CFTC order once the CFTC has obtained a year's worth of open interest data for cleared and uncleared swaps that are economically equivalent to the 28 futures and options contracts covered by the Final Position Limits Rules. This timing is a change from the CFTC's proposed rule, which could have taken effect before the CFTC obtained open interest data for economically equivalent swaps. The earliest that the CFTC could obtain the requisite information for the phase two limits would be January 2013. Accordingly, the phase two limits would not take effect until at least such time. Thereafter, these limits will be reset every two years.

Aggregation

In general, except as noted below, the Final Position Limits Rules do not require aggregation of the positions in multiple entities or funds held directly or indirectly by a passive investor unless the investor holds or controls 10% or more of each of the entities or funds (based on equity ownership or power to vote) or the funds have *identical* trading strategies.

The aggregation provisions of the Final Position Limits Rules are substantially the same as the aggregation provisions in the CFTC's proposed rules except that the final aggregation provisions retain portions of the independent account controller exception contained in the CFTC's existing position limit rules and omit the proposed "owned non-financial entity" exemption (which was intended to replace the independent account controller exception). The Final Position Limits Rules clarify that the independent account controller exemption is limited to client positions controlled by an independent account controller who trades professionally for others and does not apply to proprietary positions. The independent account controller exemption also does not apply to spot-month limits for physical-delivery Referenced Contracts.

The Final Position Limits Rules also retain the exception from the 10% equity ownership limitation for non-affiliated, passive investors in most commodity pools contained in the CFTC's existing position limit rules. However, under the Final Position Limits Rules, investors in most commodity pools that are affiliates or principals of the operators of such commodity pools are subject to the 10% equity ownership limitation unless certain requirements are met to ensure that such investors do not have knowledge of, or control over, the commodity pools' trading. In addition, all investors in commodity pools whose operators are exempt from registration under CFTC Reg. §4.13 are required to aggregate the positions of entities or funds in which such investors own or control 25% or more, without exception. Note that these exceptions from the aggregation requirements for investors in commodity pools would not apply if the commodity pools had identical trading strategies.

Finally, the Final Position Limits Rules contain an exemption from aggregation if the sharing of information among entities or funds would violate Federal law or regulations and if the entities or funds do not have actual knowledge of information necessary to comply with the aggregation requirements in the Final Position Limits Rules.

Hedging

The Final Position Limits Rules contain an exemption for "bona fide hedging transactions." However, the definition of a bona fide hedging transaction in the Final Position Limits Rules is significantly more narrow than the definition of hedging in other rulemakings under the Dodd-Frank Act (*e.g.*, the hedging definition applicable to the so-called end-user exception from clearing and the definition of major swap participant). This definition is also more limited than the exemption for "bona fide hedging transactions" in the CFTC's existing position limit rules.

The Final Position Limits Rules contain a list of enumerated hedging transactions that *may* qualify as bona fide hedging transactions and criteria that such transactions *must satisfy* to be exempted from position limits as bona fide hedging transactions. In addition, the Final Position Limits Rules clarify that the non-hedging counterparty to a bona fide hedging transaction is also exempt from position limits for such transactions if such counterparty enters into another transaction to offset the risk of the bona fide hedging transaction. The offsetting transaction would also be treated as a bona fide hedging transaction for position limits purposes.

The list of enumerated hedging transactions in the Final Position Limits Rules is largely consistent with the hedging exemption available in connection with the CFTC's existing position limit rules for certain agricultural futures contracts, including the existing exemption for "anticipatory" hedging transactions. However, unlike the hedging exemption contained in the CFTC's existing position limit rules, risk-reducing transactions that are not on the list of enumerated hedging transactions do not qualify as bona fide hedging transactions under the Final Position Limits Rules regardless of whether they meet the criteria for a bona fide hedging transaction in the Final Position Limits Rules. Market participants entering into any such non-enumerated risk-reducing transactions may request relief from position limits for such transactions from the CFTC staff under CFTC Rule §140.99 or from the CFTC under Section 4a(a)(7) of the CEA.

Existing Positions

The Final Position Limits Rules contain an exemption from aggregate position limits (but not spot-month position limits) for positions established in good faith prior to the effective date of the various provisions of the Final Position Limits Rules. Additionally, even though swaps and swaptions entered into prior to the effective date of the new position limits will be exempt from the position limits, such swaps and swaptions may be netted with post-effective date swaps and swaptions for position limits purposes.

The Position Limits Lawsuit

The Position Limits Lawsuit was filed under the CEA and the Administrative Procedures Act (the APA) and alleges that the Final Position Limits Rules may adversely impact the commodity markets and market participants, was adopted without statutory authority, is arbitrary and capricious and that the CFTC adopted the Final Position Limits Rules pursuant to a flawed process.

The Position Limits Lawsuit specifically alleges the following:

1. The CFTC **did not make statutorily mandated findings** regarding whether position limits are (a) necessary to diminish, eliminate or prevent an undue and unnecessary burden on interstate commerce caused by excessive speculation and (b) appropriate and did not give a reasoned explanation for any discretion that it exercised in establishing position limits. In adopting the Final Position Limits Rules without making such findings or giving an explanation, the CFTC acted in a manner that is arbitrary, capricious and otherwise not in accordance with law, in violation of the APA and the CEA.
2. The CFTC **did not conduct the cost-benefit analysis** required under the CEA with respect to the Final Position Limits Rules. Specifically, the CFTC failed to assess whether the actual limits, the bona fide hedging exemptions and the aggregation provisions in the Final Position Limits Rules would be effective in curbing excessive speculation and ignored substantial evidence to the contrary submitted by commenters. Additionally, the CFTC failed to collect the data that would enable it to fairly evaluate the costs to be incurred by market participants under the Final Position Limits Rules.
3. The CFTC acted in a manner that was arbitrary, capricious and not otherwise in accordance with the law in **ignoring data** demonstrating that the Final Position Limits Rules were unnecessary and would be ineffective and harmful to the U.S. economy and in **failing to collect data** (particularly with respect to swaps) necessary for a fair evaluation of the costs and benefits of the Final Position Limits Rules.

4. The CFTC violated the APA in ***failing to articulate a rational connection*** between its fact findings and the limits, requirements and restrictions in the Final Position Limits Rules.
5. The CFTC violated the APA in ***failing to provide market participants a sufficient opportunity to meaningfully participate in the rulemaking process*** for the Final Position Limits Rules because the CFTC's Notice of Proposed Rulemaking (a) did not apprise the public of the empirical data and reasoning on which the CFTC was relying to support the establishment of position limits and (b) did not give commenters fair notice of various provisions of the Final Position Limits Rules.

The Position Limits Lawsuit requests that the U.S. District Court for the District of Columbia vacate and set aside the Final Position Limits Rules.



If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

James M. Cain	202.383.0180	james.cain@sutherland.com
Catherine M. Krupka	202.383.0248	catherine.krupka@sutherland.com
Peter H. Rodgers	202.383.0883	peter.rodgers@sutherland.com
Paul B. Turner	713.470.6105	paul.turner@sutherland.com
Warren N. Davis	202.383.0133	warren.davis@sutherland.com
William H. Hope II	404.853.8103	william.hope@sutherland.com
Mark D. Sherrill	202.383.0360	mark.sherrill@sutherland.com
Ann M. Battle	202.383.0842	ann.battle@sutherland.com
Doyle Campbell	212.389.5073	doyle.campbell@sutherland.com
Meltem F. Kodaman	202.383.0674	meltem.kodaman@sutherland.com
Jennifer J. Kubicek	202.383.0822	jj.kubicek@sutherland.com
Raymond A. Ramirez	202.383.0868	ray.ramirez@sutherland.com