U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5000
Facsimile: (202) 418-5521
www.cftc.gov

Division of Market Oversight

Position Limits Roundtable: Staff Questions

Below is a series of questions concerning comments previously received in response to notices of proposed rulemakings regarding position limits.[1] Staff invites participants at the June 19, 2014 staff roundtable to give brief answers to any or all of the questions during the roundtable, and welcomes written comments from the public during the re-opened comment periods.[2]

First Session—Hedges of a physical commodity: Gross Hedging, Cross-Commodity Hedging, Anticipatory Hedging.

Gross hedging. Some commenters requested that a bona fide hedging exemption be adopted for a derivative position entered by a commercial enterprise that, in its business judgment, is (1) reducing some identified specific risk, or (2) reducing the risk of an operating unit of a commercial enterprise, regardless of whether the overall risk of the commercial enterprise is increasing. CEA Section 4a(c)(2)(A)(ii) requires a bona fide hedge to be "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise."

1. What information collected in the normal course of business can be produced to the Commission for analysis in support of a request for an exemption by a commercial enterprise that is, in its business judgment, reducing an identified specific risk or the risk of an operating unit?

2. What standard should be applied to differentiate such a proposed exemption from speculation?

Cross-commodity hedging. Some commenters have suggested that the qualitative factor of the substantially related test is an acceptable factor for identifying cross-commodity hedges that should be recognized as bona fide.[3] Some commenters have requested that the quantitative factor be removed, asserting that numerous legitimate cross-commodity hedging strategies would not meet the quantitative factor. In addition, cross-commodity hedging in a physical-delivery

---

[1] *See* 78 Fed. Reg. 75680 (Dec. 12, 2013) ("re-proposal") and 78 Fed. Reg. 68946 (Nov. 15, 2013) ("aggregation proposal").

[2] *See* 79 Fed. Reg. 30762 (May 29, 2014).

[3] *See* re-proposal at 75716 for a discussion of a proposed two-factor (qualitative and quantitative) non-exclusive safe harbor to meet the substantially related test for cross-commodity hedges. Under the substantially related test, fluctuations in value of the position in the commodity derivative contract (or the commodity underlying the commodity derivative contract) must be substantially related to the fluctuations in value of the actual or anticipated cash position.

commodity derivative contract would be subject to the five-day rule, which generally would not recognize cross-commodity hedges in physical-delivery commodity derivative contracts as bona fide as the last trading day approaches.

Review standard for and documentation in support of qualitative factor.[4]

3. What review do you currently perform in the normal course of business that could be made available to the Commission regarding the reasonable commercial relationship between the commodity underlying a derivative contract and the target of a cross-commodity hedge?

4. What standard should be applied to the Commission's review of a commercial enterprise's assessment of the reasonable commercial relationship?

Holding a cross-commodity hedge as delivery obligations approach.

5. What risk management objectives do you address by holding a cross-commodity hedge in a physical-delivery commodity derivative contract through the last few days of trading?

Anticipatory hedging.

Firm bids and offers as if options. Some commenters have characterized firm bids or offers that are open for a defined time period as analogous to granting put options or call options to customers.

6. How do you identify, measure, monitor and control the risks of option-like firm quotes?

7. What records are kept in the normal course of your business regarding firm bids or offers, which could be made available to the Commission

Anticipatory merchandising. Some commenters have suggested that a merchant may anticipate purchasing or selling a commodity at a later date (for example, consistent with prior historical volumes of commodity handled). Some commenters with a historical record of buying a commodity in the normal cash market channel have indicated a desire to establish price risk exposure to the commodity by establishing a long position in a commodity derivative contract today or, alternatively, may anticipate selling the commodity at a later day (similarly, consistent with prior historical volumes of commodity handled) and desire to establish price risk exposure to the commodity by establishing a short position in a commodity derivative contract today.

---

[4] *See* re-proposal at 75716 for a discussion of the qualitative factor (requiring the target commodity to have a reasonable commercial relationship to the commodity underlying the commodity derivative contract).

8. What public policy reasons are there to recognize an exemption for such anticipatory merchandising that establishes price risk exposure?

9. Are there circumstances under which your commercial enterprise identifies, measures, monitors and manages other risks arising from such anticipatory merchandising, and what are those risks?

Synthetic fixing of un-fixed price forward contracts. Some commenters have noted that a merchant may have established unfixed-price forward contracts that may expose the commercial enterprise to operational risk of counterparty performance. To ensure the making or taking of delivery, some commenters establish a position in a physical-delivery futures position. Such commenters seek recognition of that position as a bona fide hedge to offset the risk of potential failure by the cash counterparty to perform on an unfixed-price forward contract.

10. What public policy reasons are there to recognize an exemption for such price fixing uses of derivative contracts?

Unpriced physical purchase or sale commitments. The Working Group of Commercial Energy Firms comment letter requests that unpriced physical purchase or sale commitments, where the commercial enterprise has not yet obtained a pair of unfixed-price purchase and unfixed-price sale commitments, be recognized as the basis of a bona fide hedging position. The Commission's re-proposal recognizes there can be a gradation of probabilities that an anticipated transaction will occur.[5]

11. What are the circumstances, if any, where a commercial enterprise can establish that the nature of their commercial operation is such that it has committed physical or financial resources towards the anticipated transaction ("plus factors")?

12. How should any such plus factors be considered (including as a presumption for example?) that the unfixed-price commitment (either a purchase or a sale), although not yet entered, is likely to occur? If so, what records do you keep in the normal course of business regarding plus factors that could support the Commission in recognizing the anticipatory paired unfixed-price commitments as the basis of a bona fide hedge?

[5] *See* re-proposal at 75719, Request 3.

Second Session—Process for Non-enumerated Exemption.

Non-enumerated hedges. Some commenters have requested that Regulation 1.47 be retained. That regulation provides a time-limited process for consideration of non-enumerated hedges.[6] The following questions address the possible retention of Regulation 1.47:

1. Should specific factors be considered in review of applications filed under Regulation 1.47, such as the policy objectives in CEA Section 4a(a)(3)?[7]

2. Should the regulation incorporate stay procedures similar to Regulation 40.6, including the associated 30-day public comment period within the stay?[8]

Pre-approval reliance on filing. Some commenters have suggested letting market participants rely on a filing until such time as the Commission has reviewed the filing, effectively a grant of bona fide hedging status pending a determination on the filing. Current Regulation 1.47 does not permit reliance on a filing before approval.

3. Are there alternatives to the procedure in Regulation 1.47 (such as exchange review and approval) that would support a pre-approval reliance on a non-enumerated hedge filing?

4. What are the public policy considerations?

---

[6] CFTC Regulation 1.47, 17 CFR 1.47 (2010), has a 30-day review period for initial submissions, no explicit standards for review, no provision for a public comment period, and no ability to extend the 30-day review period if additional time is needed for an adequate review, although the Commission may seek additional information from the submitter.

[7] The policy objectives in CEA Section 4a(a)(3) guide the Commission in setting position limits, to the maximum extent practicable, in its discretion, (i) to diminish, eliminate, or prevent excessive speculation, (ii) to deter and prevent market manipulation, (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.

[8] By way of background, CFTC Regulation 40.6(c), regarding self-certification of exchange rules, provides the Commission with an additional 90 days for review when it stays a certification that (1) raises novel or complex issues that require additional time to analyze, (2) is inadequately explained, or (3) potentially is inconsistent with the Act or Commission regulations. Regulation 40.6 also provides for a 30-day public comment period within the 90-day stay period.

Third Session—Spot-month Limits and Conditional Exemption.

Spot-month limit and conditional exemption. The re-proposal would provide a conditional spot-month limit exemption that allows traders who do not hold or control positions in the spot-month physical-delivery referenced contract to acquire positions in cash-settled contracts up to five times the spot-month limit level. Some commenters have suggested that a conditional spot-month limit exemption equal to 125% of estimated deliverable supply may have the unintended consequence of draining liquidity for a physical-delivery core referenced futures contract. Other commenters have noted that market participants may be active in both physical-delivery and cash-settled commodity derivative contracts during the spot-month. Some commenters have expressed concern that a single physical-delivery swap with volumetric optionality would preclude use of the proposed conditional spot-month limit exemption.

1. *Need for conditional spot-month limit exemption*. If the spot-month limit on a physical-delivery futures contract is updated in accordance with a reasonable deliverable supply estimate, would that increased level permit sufficient liquidity for bona fide hedgers, including in cash-settled contracts? That is, would an increased spot-month limit level, based on 25 percent of the current estimate of deliverable supply, mean that there is no need for a conditional spot-month limit exemption?

2. *Alternative method for setting spot-month limit*. Do you recommend any alternative methodology for setting the level of the spot-month limit in a cash-settled contract, in lieu of 25 percent of deliverable supply, particularly in a cash-settled core referenced futures contract? If so, please discuss how that method is consistent with Core Principle 5 and the policy objectives in CEA Section 4a(a)(3).

3. *Conditional spot-month limit exemption*. What purposes, other than purposes that would qualify as the basis of a bona fide hedge, are there for a trader to hold into the spot-month both a large position in a cash-settled commodity derivative contract and a large position in a physical-delivery commodity derivative contract?

4. What impact, if any, have the current conditional limits had on the market?

5. Do conditional limits impact convergence in the natural gas market? If so, how? Has a lack of conditional limits in other commodities impacted convergence in those markets?

6. How would changing the current conditional limits affect the utility of the physically-delivered and cash-settled contracts for speculators and commercial hedgers?

Fourth Session—Aggregation of Positions.[9]

In circumstances where one firm owns an equity interest in another firm, some commenters have suggested that the only relevant criterion for aggregation should be whether one firm controls the trading of the other.

1. For ownership interests over 50 percent, what organizational structures do you have in place that would indicate that there is an appropriately high degree of separation between the owner and the owned entity, in light of the statutory purposes of position limits, such that the two should not be aggregated? For example, in this situation, what organizational structures would prevent the owner and owned entity from using the limits that would apply to them separately (if they are not aggregated), in order to engage in excessive speculation or market manipulation?

2. What organizational difficulties do you face in complying with the proposal to require aggregation when there are ownership interests over 50 percent?

3. Should the Commission consider granting an aggregation exemption to the separately organized operating units of a commercial enterprise, regardless of ownership interests? Should such exemption be conditioned on independence of control of trading decisions, similar to the exemption for an eligible entity with an independent account controller?

4. *Substantially identical trading strategies*. What concerns do you have regarding the facts and circumstances determination concerning whether trading strategies are "substantially identical"?

[9] Section 4a(a)(1) of the CEA requires aggregation of an entity's positions on the basis of either ownership or control of the entity, and also requires aggregation of positions held or trading done by two or more persons acting pursuant to express or implied agreement. *See* the aggregation proposal at 68951.