

Proposed Risk Management Exemption from Federal Speculative Position Limits

Notice of Proposed Rulemaking
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Statutory Basis for Speculative Position Limits

- “Excessive speculation ... causing sudden or unreasonable fluctuations or unwarranted changes in the price of [commodities] is an undue and unnecessary burden on interstate commerce...” CEA § 4a(a)
- The Commission is authorized to fix limits on trading that may be done or positions that may be held on any exchange as necessary to “diminish, eliminate, or prevent such burden” CEA § 4a(a)

Regulatory Structure

1. Levels of speculative position limits
2. Exemptions from the limits (for hedging, spreading/arbitrage, and other positions)
3. Policy on aggregating commonly owned or controlled accounts in applying the limits

Federal vs. Exchange-Set Limits

- CFTC sets Federal limits for agricultural commodities designated in Regulation 150.2
 - CBOT corn, oats, soybeans, soybean oil, soybean meal, wheat
 - MGE hard red spring wheat, white wheat
 - ICE Futures U.S. (NYBOT) cotton No. 2
 - KCBOT hard winter wheat
- Exchanges adopt position limitations or position accountability rules for other commodities subject to CFTC oversight (CFMA Core Principle 5)

Current Exemptions from Federal Position Limits

- Regulation 150.3 lists positions that may be exempted from (and thus exceed) the Federal limits, for example:
 - Bona fide hedging transactions
 - Multi-advisor pools with independent account controllers
- Exemptive rules last amended in 1991

Changes in Trading Practices

- Pension funds and other investors seek commodities price exposure (including agricultural commodities) to diversify portfolios
- Index-based positions in agricultural commodities could exceed position limits
- In 1991, the CFTC grants the first (of several) hedge exemption to a swap dealer for off-exchange (OTC) index-based exposure opposite a pension fund:
 - Off-exchange position:
 - Pension fund (long) ↔ swap dealer (short)
 - On-exchange position:
 - Swap dealer (long) ↔ futures market (short)

Hedge Exemptions Subject to Conditions to Protect Market

- The swap dealer's futures positions must offset specific price risk
- The dollar value of the futures positions cannot exceed dollar value of the underlying risk
- The futures positions cannot be carried into the delivery month

Recent No-Action Letters Recognize Another Type of Index-Based Trading

- Index funds offer investors commodities exposure by agreeing to **track** an index (as opposed to holding a swaps position **directly linked** to the price of an index)
- These index-based positions differ enough that a hedge exemption is not appropriate
- Instead, the fund is granted no-action relief from speculative position limits for this otherwise legitimate investment strategy (subject to conditions to protect the markets)
 - CFTC Letter 06-09 (April 19, 2006)
 - CFTC Letter 06-19 (September 6, 2006)

Proposed Amendments to Part 150

- A proposed new exemption for risk management positions would formalize a risk management exemption from speculative position limits for:
 - Intermediaries, such as index funds, that pass price risks on to customers; and
 - Pension funds and other institutional investors seeking to diversify by adding an allocation to commodities exposure
- The prior policy of granting risk management exemptions for swap dealers would remain in effect

Conditions for the Exemption

- The proposed exemption includes conditions to protect the marketplace from ill effects:
 - “Risk management position” defined – results from a “fiduciary obligation” to track an index or a “portfolio diversification plan”
 - “Broadly diversified Index” defined (not more than 15% in any one agricultural commodity; agricultural commodities not more than 50% of the index)
 - Positions must be “passively managed” (must track the index with limited discretion as to trading decisions – the portfolio is not managed with an eye toward taking advantage of short term market trends)

Conditions for the Exemption

- Positions must be “unleveraged” (fully offset by cash or profits on the positions), so that significant price changes will not cause rapid liquidation
- Positions may not be carried into the spot month (when markets are most vulnerable to manipulations or squeezes)
- Positions must be “established and liquidated in an orderly manner”

Other Provisions

- The proposed regulations include a listing of the information that must be provided in an application for a risk management exemption
- Entities holding positions pursuant to a risk management exemption must report to the Commission if they know, or have reason to know, that any person holds a greater than 25% interest in the position (to alert the Commission in case somebody is attempting to use the exemption as a means to avoid speculative position limits)

Questions

- (1) Are any of the proposed conditions for receiving a risk management exemption unnecessary and, if so, why? Alternatively, should any of the proposed conditions be modified and, if so, why?
- (2) Should any other conditions, in addition to those set out in these proposed rules, be imposed as a prerequisite for receiving a risk management exemption? If so, what is the rationale for such additional conditions (i.e., what potential harm would they address)?
- (3) Is there any type of index-based trading that should be covered by the proposed rules, but is not? If so, how should the proposed rules be revised to apply to such trading?
- (4) The proposed rules would allow for a risk management exemption in the case of short-only futures or futures equivalent positions used to manage risks in connection with a “bear market index.” Would any of the exemptive rules, as proposed, create potential problems as applied to such an index? For example, in applying the definition of “unleveraged position,” would problems be encountered in comparing the notional value of an unleveraged short futures position to the value of the cash, margins and accrued profits on such position?

Questions

- (5) Should the proposed rules impose any restrictions or conditions regarding how broad- or narrow-based an index should be if a position based on the index is to qualify for an exemption? For example, with respect to narrow-based indices reflecting specific industry or commodity sectors, should the Commission be concerned that a narrow-based index composed entirely of agricultural commodities – for example, 25% each of corn, wheat, oats and soybeans – could operate as a mechanism for evading speculative position limits in one or more of those commodities?
- (6) The proposed rules list the information that must be provided in an application for a risk management exemption. Are the requirements set out in the proposed rules appropriate? Should the requirements be revised and, if so, how?