Commodity Futures Trading Commission
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Proposal to Set Position Limits in the Energy Futures and Options Markets

The Commodity Futures Trading Commission (CFTC) is proposing to set position limits for futures and option contracts in the major energy markets. In addition, the proposal establishes consistent, uniform exemptions for certain swap dealer risk management transactions while maintaining exemptions for *bona fide* hedging.

The CFTC is directed in its original 1936 statute to set position limits to protect against the burdens of excessive speculation, including those caused by large concentrated positions.

Commodity Exchange Act, Section 4a(a): For the purpose of diminishing, eliminating, or preventing such burden [to interstate commerce], the Commission shall, from time to time…proclaim and fix such limits on the amounts of trading which may be done or positions which may be held by any person under contracts of sale of such commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility, or on an electronic trading facility with respect to a significant price discovery contract, as the Commission finds are necessary to diminish, eliminate, or prevent such burden.

The CFTC currently sets position limits in certain agriculture markets. The CFTC sets limits for all-months-combined (AMC), single-month and the spot-month in certain agriculture commodities. Limits apply to aggregate positions in futures and options combined, plus mini-sized contracts in the same commodity. There are exemptions for *bona fide* hedging transactions involving commodity inventory hedges and anticipatory purchases or sales of the commodity.

Position limits existed in the energy markets until 2001. The New York Mercantile Exchange (NYMEX), with CFTC approval set and enforced position limits in the energy futures markets until 2001. The position limits applied to AMC, single-month and spot-month. In 2001, NYMEX substituted accountability levels for AMC and single-month limits and set position limits only in the spot month.

The Commodity Exchange Act directs the CFTC to act prospectively, as necessary, to curb or prevent excessive speculation that may burden interstate commerce. The CFTC need not demonstrate that there has been excessive speculation in the regulated derivatives markets for the major energy commodities.

The proposed rulemaking leverages the CFTC's experience setting position limits in the agriculture markets.

The energy position limits proposal uses the same "open interest" formula as the one used in CFTC guidance to exchanges. The proposal uses the same formula for the AMC position limits. The approach to setting the level of the spot-month limit in the physical delivery contract also is the same.

The proposed energy position limits build upon the agricultural limits in several ways. The proposed energy limits would be responsive to the size of the market and administratively reset on an annual basis, rather than change only with a Commission rulemaking.

The proposed energy limits differ from the agriculture markets by establishing aggregated position limits. These limits aggregate positions: across physically-settled and cash-settled contracts; across reporting markets; and at the owner level. Rules for agricultural products permit disaggregation for independently controlled positions.

The Commission proposal would set position limits on four referenced energy commodities.

The proposed limits would cover Henry Hub natural gas, light sweet crude oil (such as West Texas Intermediate or WTI), New York Harbor No. 2 heating oil and New York Harbor gasoline blendstock.

The proposed rulemaking sets reasonable limits in the energy markets to prevent burdens that could arise from excessive concentration in the futures and options markets.

The proposed speculative position limits are intended to limit the concentration of positions and promote fair and orderly markets. The CFTC's proposed framework is designed to facilitate trading activity that promotes the pricing and risk management functions of the covered contracts, while prohibiting the concentration of large positions in the accounts of one or a few traders.

The aggregate limits are set by formula based on open interest. The all-months-combined position limit would be 10 percent of the first 25,000 contracts of open interest and 2.5 percent of open interest beyond 25,000 contracts. The single-month position limit is set at two thirds of the AMC position limit. The spot-month limit in the physical delivery contract is 25 percent of the estimated deliverable supply.

To promote competition, for a small reporting market, the AMC limit would be up to 30 percent of a contract's total open interest on that exchange. The single-month limit that would apply to a small exchange would be equal to two thirds of that value – or as much as 20 percent – of the total open interest on that exchange. For new reporting markets, a de minimis AMC limit would be the greater of 5,000 contracts or one percent of all open interest in a referenced energy commodity contract.

A trader holding cash-settled contracts would be subject to a spot-month position limit of five times the level fixed for the cash-settled contract's physically-settled counterpart if the trader holds no physically-settled contracts in the spot month. Otherwise, traders would be subject to the same limit fixed for a contract's physically-settled counterpart. Pursuant to recently adopted exchange rules, this is the same methodology for spot-month speculative position limits that applies to cash-settled Henry Hub natural gas contracts on NYMEX and ICE, beginning with the February 2010 contract months.

In addition to exempting *bona fide* hedgers from position limits, the proposed rule establishes a consistent framework for certain swap dealer risk management exemptions.

The proposed rulemaking maintains exemptions for entities using the futures markets to hedge commercial risks. Those traders, such as an airline purchasing futures contracts to hedge the cost of fuel, would qualify for a *bona fide* hedging exemption from the proposed position limits.

The proposed rulemaking brings uniformity to swap dealer exemptions; exemptions would be consistent, and the names of the exempted dealers would be publicly disclosed. Swap dealers establishing positions to offset customer initiated swap positions could qualify for a limited risk management exemption for positions held outside the spot month. The limited risk management exemption for swap dealers would be administered by the CFTC and capped at two times an otherwise applicable proposed position limit (*i.e.*, an AMC or single-month limit).

> To qualify for a swap dealer risk management exemption, the dealer must file an exemption application and update the application annually. The swap dealer also must provide monthly reports of their actual risk management needs and maintain records that demonstrate their net risk management needs. The CFTC would publicly disclose the names of swap dealers that have filed for an exemption after a six-month delay.

The CFTC's proposal treats *bona fide* hedgers and swap dealers similarly to the practice of certain exchanges that independently administer an agricultural speculative position limit framework. The proposed regulations would count *bona fide* hedging transactions against a trader's ability to hold speculative positions. For example, a trader holding *bona fide* hedging positions greater than a proposed Federal speculative position limit would not be able to simultaneously hold a speculative position. Further, a trader's swap risk management position also would count against a trader's ability to hold speculative positions.