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Clients&FriendsMemo

CFTC Proposes to Set Position Limits in the Energy Futures Market

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The Commodity Futures Trading Commission (the "CFTC" or "Commission") has published a release containing a proposed rulemaking that would (i) establish **federal speculative position limits** for futures on **four major energy commodities**;[1] (ii) establish **new standards for obtaining exemptions** from such limits for *bona fide* hedging transactions and for certain swap dealer risk management transactions; and (iii) establish standards for **aggregating positions** in energy contracts.[2] The publication of the release was initially approved on January 14, 2010 by a four-to-one vote at a public meeting.[3]

- The rulemaking would be the CFTC's first imposition of position limits on non-agricultural commodities (the exchanges currently may regulate positions on these commodities contracts).
- Although the rulemaking is based in format on the existing rule structure for agricultural commodities, it is more restrictive in that, for example: (i) it would expands the positions required to be aggregated; (ii) it would expands the accounts required to be aggregated; and (iii) it would limit the benefit of any exemptions for hedging positions.

If adopted, the rule proposal would substantially increase the power of the CFTC, with an indication of further increases to come, on the basis of limited empirical evidence—in fact, in light of evidence published by the CFTC's own staff that would argue that adoption of the rule proposed is not

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1 The proposed rule would cover four "referenced energy contracts"—(1) Henry Hub natural gas, (2) light sweet crude oil prices ("West Texas Intermediate" or "WTI"), (3) New York Harbor No. 2 heating oil, and (4) New York Harbor gasoline blendstock, *and any other contract that is based* on one of these contracts. The language relating to contracts that are "based on" the enumerated contracts implies that the limits would apply to all economically similar contracts that are subject to the CFTC's jurisdiction. Thus, the limits would apply to what are known as "look-alike" energy contracts that trade on other exchanges or trading platforms, including "exempt commercial markets," such as ICE's cash-settled natural gas contract that settles directly to the settlement price of NYMEX's physically-delivered natural gas futures contract, and that serve as significant sources of price discovery.

2 *See CFTC's Notice of Proposed Rulemaking: Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations (the "CFTC Proposal" or "NPR"), 75 Fed. Reg. 4144 (Jan. 26, 2010).*

3 Normally, rules proposed by the CFTC are simply communicated via the *Federal Register*. The fact that the Commission held a public meeting (which is the first in eight years) to consider this proposal signifies its importance in a rather politically charged environment.

necessary (see footnote 11 and accompanying text). Given that the CFTC historically has been an agency that took into serious consideration empirical evidence, this would of itself be a policy development of note.

Beyond the powers that the CFTC has indicated that it may now exert, the CFTC has also indicated that it may in the future determine that it can and should limit market participation not merely by individual persons (or groups of persons acting collectively), but in fact by whole categories of persons acting independently of each other. For example, the CFTC might in the future set position limits not only on the positions of a single fund or of all funds controlled by a single adviser, but even of all funds in the aggregate. Such a power in the hands of the CFTC—to impose collective ownership limits on all entities of a particular type—could have very profound economic implications and implications as to the power of the CFTC to influence and control market participants. For example, if all funds in the aggregate were subject to CFTC position limits, how would the CFTC decide how to allocate its granted position limits between the various funds? Could such a power be used to favor one market participant over another? Ultimately, the questions raised by the CFTC rule proposal go well beyond whether the rule is well drafted as a technical matter. The proposal raises much more important questions of economic policy; and still more important questions of the appropriate degree of government power and how that power will be exercised.

This memo is generally divided into five parts. The first part contains a summary of the existing law of position limits (that may be skipped over by those familiar with the area). The second provides a fairly detailed discussion of the CFTC's rule proposal. The third and fourth parts discuss some of the rationale for the rule proposal and the potential direction of future rule making. The final part of this memo describes some of the positions taken by the individual CFTC Commissioners.

I. Current Regulatory Framework

The CFTC's current regulatory framework for Federal speculative position limits consists of three elements: 1) the levels of the Commission-set speculative position limits, 2) certain exemptions from the limits (e.g., for hedging, spreading or arbitraged positions), and 3) the requirements as to aggregating related accounts for purposes of applying the limits.

A. Speculative Position Limits

1. In General

Currently, the CFTC sets speculative position limits on futures contracts for a limited group of agricultural commodities. As to all other commodities, including energy commodities, each individual exchange establishes and enforces its own speculative position limits or position accountability levels, subject to the CFTC's oversight.[4] The limits apply to positions held by any one person, including a direct investor, such as a pool, or to a person who may control investments, such as a commodity pool operator ("CPO") or commodity trading advisor ("CTA"), as well as to those positions held by two or more persons "acting pursuant to an expressed or implied agreement or understanding."

Under the current regime, traders are subject either to **position limits** that bar them from acquiring contracts that quantitatively exceed a specific number of outstanding contracts or to exchange-imposed **position accountability rules** for non-spot months that require persons holding a certain number of open contracts to report the nature of their positions, trading strategy, and hedging needs to the exchange, upon the exchange's request.[5]

Although both the CFTC and exchanges share responsibility for regulating the size of positions held or controlled by market participants, the CFTC and the exchanges have slightly different goals in establishing and enforcing such limits. While position limits are imposed by the CFTC to prevent "excessive speculation" that may cause harmful fluctuations in commodity prices, limits imposed by exchanges serve a more narrow purpose, to reduce or prevent "market manipulation or congestion."[6] This difference in regulatory objective is cited by the CFTC as grounds for imposing a more comprehensive position limit regime, at least for the energy complex.

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4 The CFTC administers position limits on a limited group of agricultural commodities that are enumerated in CFTC Rule 150.2 (corn, oats, wheat, soybeans, soybean oil, soybean meal, and cotton) as well as for security futures contracts, which are set forth in CFTC Rule 41.15(a)(3). On other products, individual contract markets establish and enforce their own limits or position accountability rules, subject to CFTC oversight and separate authority to enforce exchange-set speculative position limits. Under the Commodity Futures Modernization Act of 2000 (the "CFMA"), each exchange, as a condition for contract market designation, is generally required to set limits for commodities not subject to CFTC-set speculative position limits (*i.e.*, commodities other than certain agricultural goods), except for markets where the threat of excessive speculation or manipulation is nonexistent or low.

5 In lieu of position limits for non-spot months, the CFTC permits exchanges to adopt more flexible "position accountability" standards for eligible non-agricultural contracts, including contracts on financial instruments, intangible commodities and certain tangible commodities with large open interest, high daily trading volumes and liquid cash markets. *See 61 Fed. Reg. 10891 (Mar. 18, 1996).* Position accountability rules require traders who own or control positions in excess of exchange established thresholds to provide the exchange, upon request, information regarding the nature of the position and the trading strategy employed, *i.e.*, to be held be accountable for large positions. *Appendix B to Part 38 of the CFTC's regulations.*

6 Section 4a(a) of the CEA authorizes the CFTC to set "limits on the amounts of trading which may be done or positions which may be held by any person" in order to protect such markets from "excessive" speculation that may cause "sudden or unreasonable fluctuations or unwarranted changes in the price of [a] commodity." In addition, Core Principle 5 of CEA Section 5(d) requires contract markets to adopt position limits or position accountability standards for speculators "where necessary and appropriate" to reduce the potential threat of "market manipulation or congestion." *See Section 5(d)(5) of the CEA*. Furthermore, position limits are not considered necessary for markets where the threat of excessive speculation or

2. For Energy Futures

Energy futures and option contracts have never been subject to CFTC-set speculative position limits. Instead, they are subject to limits imposed by the exchanges on which the contracts are traded, currently NYMEX or ICE. The NYMEX's energy futures and option contracts are subject to exchange-set position accountability levels during non-spot months and to hard speculative position limits during spot months. ICE's "look-alike" natural gas contract, and ICE Europe's WTI crude oil contract are also subject to position limits that are "comparable" to those of NYMEX, notwithstanding that the former trades on an "exempt commercial market" ("ECM"), while the latter on a non-U.S. exchange.[7]

B. Exemptions

The CFTC and futures exchanges generally grant exemptions from position limits (or at least allow higher position limits) for *bona fide* hedging transactions, *i.e.*, transactions whose purpose is to offset price risks incidental to commercial cash or spot operations, and for some transactions involving spreads, straddles. In general, if an exemption is granted, an exemption level is set at an amount higher than the applicable speculative limit so as not to give a limitless hedge exemption.

Also exempted are CPOs or CTAs with commonly-owned but independently-controlled market positions. Such accounts must be carried for an "eligible entity" (which includes commodity pools and their partners, CPOs and CTAs) and may not include contracts in any spot month to which a position limit applies. The overall positions held or controlled by each independent account controller may not exceed the speculative position limits, and the CFTC reserves the right to make a "call" on the person claiming the exemption for additional information concerning such person's positions and support for the claim that the account controllers for these positions are acting independently. *See CFTC Rule 150.3(a)(4)*.

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manipulation is nonexistent or very low, such as major foreign currencies and financial futures having liquid cash markets. *See 66 Fed. Reg. 42256, 42280 (August 10, 2001).*

7 The authority to impose position limits on ICE's natural gas contract, which settles directly to the settlement price of NYMEX's physically-delivered natural gas contract, is derived from legislation passed in 2008, the CFTC Reauthorization Act of 2008, granting the CFTC authority to apply position limit and position accountability core principles to ECM contracts that have become sources of "significant price discovery" ("significant price discovery contracts" or "SPDCs"). As for ICE Europe's WTI contract, which directly cash-settles to the price of a similar physically-settled NYMEX futures contracts and which is offered to U.S. customers under no-action relief granted by the CFTC in 1999, the authority to impose position limits is more indirect. As a condition for continued no-action relief, ICE Europe is now required to implement position limits for all NYMEX-linked contracts in a manner that is "comparable" to limits that NYMEX applies to its contracts. *See CFTC No-Action Letter 08-09 (June 17, 2008).*

C. Aggregation

The CEA deems all positions in accounts for which any trader has a financial interest or otherwise controls or directs trading to belong to that trader. *CEA Section 4a(a)*. This policy, known as the "Aggregation Policy," also aggregates positions held in separate accounts of two or more persons acting pursuant to an expressed or implied agreement or understanding. *Id*. Thus, positions that are subject to common ownership or control or that are held or accumulated pursuant to an "agreement or understanding" must be aggregated.

The Aggregation Policy applies with equal force to positions governed by exchange-set position limits. *See CFTC Rule 150.5(g)*. Guidance that the CFTC provides for compliance with its core principles expressly states that contract markets should have aggregation rules that apply to those accounts under common control, those with common ownership (as discussed below), and those traded according to an express or implied agreement. Contract markets are permitted to establish more stringent aggregation policies than those required by the CFTC. *CFTC Rules, Part 38, Appendix B.*

Accounts are generally considered to be under a common ownership for any person who has a 10 percent or greater financial interest in such accounts. *CFTC Rule 150.4(b)*. Thus, a CPO or CTA must aggregate positions in all accounts that it controls or has at least a 10 percent financial interest in. Likewise, each participant with a 10 percent or greater interest in a partnership account must aggregate the entire position of the partnership—not just the participant's fractional share—together with each position the participant may hold separately from the partnership. Moreover, a pool comprised of multiple traders must aggregate the positions of those traders as if it were a single trader. *CFTC Rules 1.50.4 & 150.5(g)*. However, the financial interest threshold is 25 percent for a limited partner, shareholder, or other similar pool participant of a pool where the CPO is exempt from registration under CFTC Rule 4.13. *See CFTC Rule 150.4(c)(3)*.

An exception to the aggregation rules is provided for traders who are also limited partners or shareholders of the pool and who have no knowledge of, or control over, the positions of the pool, nor direct, day-to-day supervisory authority or control over the pool's trading decisions. *CFTC Rule 150.4(c)(2)(i-iii)*. Also exempted are CPOs or CTAs with commonly-owned but independently-controlled market positions. *CFTC Rule 150.3(a)(4)*. Since CTAs are presumed to control managed trading accounts, advisers to several funds will generally be required to aggregate the positions in those accounts unless they delegate control over an account to someone else. Likewise, large fund investors will generally be required to aggregate the positions they hold in such funds unless they have no knowledge or control over such positions.

II. Proposed Regulatory Framework

If adopted in its current form, the proposed rule would establish Federally-set position limits for four major energy commodities, exemptions for *bona fide* hedging transactions, a risk management exemption for swap dealers, and revised requirements for the aggregation of such positions. The proposed rule is divided into four parts: 1) position limits for "referenced energy contacts" *(Proposed CFTC Rule 151.2)*; 2) exemptions for referenced energy contracts *(Proposed CFTC Rule 151.3)*; 3) aggregation of positions *(Proposed CFTC Rule 151.4)*; and 4) reports that are required to be made in connection with positions in referenced energy contracts *(Proposed Part 20 of CFTC Rules)*.

A. Speculative Position Limits

The proposed rule is modeled on the existing position limit regime in effect for agricultural commodities, where limits are set by the CFTC rather than the exchanges. It would apply concurrently to any exchange-set limits, and therefore, be in addition to, and not a substitute for, an exchange's existing speculative position limit and accountability requirements, with the added caveat that such exchange-set limits or levels could not be set at a level higher than the CFTC limits.[8]

As proposed, limits on the level of speculative positions held in the energy futures markets would be set in all months combined, in each month, and in the spot month. However, unlike the existing agricultural position limit regime, the proposed rule would create an aggregate set of limits *across markets for similar contracts* in addition to exchange-specific limits for specific products. That is, it would establish a two-tiered framework that would capture large positions across markets as well as at each exchange. The first tier would aggregate positions across all markets for the same commodity, and thus would capture, for example, speculative positions in all Henry Hub natural gas contracts traded on multiple exchanges. This tier would aggregate positions of a trader held, for example, on both ICE and NYMEX, including both cash settled and physical delivery contracts. According to the CFTC, the first tier is intended to establish an "outer bound" for speculative positions in the energy futures markets.

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[8] One of the stated objectives of the proposed rulemaking is to allow the CFTC "to shape the requirements of exchange-set position limits as measures that guard[ ] against excessive speculation in accordance with the purposes and finding of section 4(a)(a) of the Act." *See 75 Fed. Reg. at 4146.* Indeed, the rulemaking notice wistfully alludes to the pre-CFMA ability of the CFTC "to more directly shape the specific requirements of exchange-set speculative position limit and accountability rules through approving such rules prior to implementation." By providing a ceiling to exchange-set limits, the CFTC will do considerably more than *shape* such limits.

A second tier of limits would establish what the CFTC describes as a "class" limit that would apply in a more narrow fashion to specific classes of contracts on each exchange. This tier would distinguish between cash and physical settlement, and in contrast to the first tier, would be limited to positions held on one exchange. The limits would apply to contracts in a particular commodity on a single market that settle in the same way. While the CFTC doesn't use this term, it appears that the "class" limit would set an "inner bound" of limits that could not be breached.

While the aggregate limit would stop a trader from taking large positions on the same side of the market in a particular commodity, the class limit would bar a trader from establishing excessively large positions on opposite sides of the market in physically delivered and cash-settled contracts in the commodity. In each tier, however, the limits would be applied to all months combined and single months based upon an open-interest formula that is identical to the formula that the CFTC already has in place for exchange-set position limits in current Rule 150.5(c). Under this formula, all months combined limits would be set at 10 percent of the first 25,000 contracts outstanding plus 2.5 percent of the remaining open interest.[9] The limits for single months would be two-thirds of the all months combined limit.[10] Netting outside the spot month would be permitted for different classes of the same contract and for contracts across different exchanges.

For the spot month, the formula would be based on deliverable supply rather than open interest. The spot month limit for physically delivered contracts would be 25 percent of estimated deliverable supply, the same ratio that the CFTC uses to set spot month limits in the agricultural futures markets. For cash settled contracts, the spot month limit would be five times the limit on physically delivered contracts, but only if the trader did not hold any physical contracts in the spot month.

For the second tier, each all-months-combined class limit would be set at 30 percent of a contract's open interest on that market, but limited to a level no greater than the aggregate limit. The single month limit would be set at two-thirds of the all-months-combined limit. All of the limits would be reset annually.

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9 For smaller markets, the all months combined limit would be up to 30 percent of a contract's 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 markets the minimum all months combined limit would be the greater of 5,000 contracts or one percent of all open interest in the reference contract. Cash-settled contracts would have position limits of five times the level for the physically-settled counterpart if the trader holds no physically-settled contracts in the spot month.

10 In practical terms, what this means is that the all months combined limit would be set prospectively at 98,200 contracts for Light Sweet Crude, 8,900 for New York Harbor Gasoline Blendstock, 13,100 for New York Harbor No. 2 heating oil, and 117,300 for Henry Hub Natural Gas according to CFTC estimates.

B. Exemptions

The proposed rule would create a *bona fide* hedge exemption for energy traders hedging inventory holdings of the underlying physical commodity or anticipatory trades in the physical commodity. However, the proposed rule would count *bona fide* hedging transactions against a trader's ability to hold speculative positions. Thus, 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. Exchanges would be responsible for administering these exemptions.

The proposed rule would also establish a limited risk management exemption for swap dealers, who would not be permitted to use the exemption for *bona fide* hedging transactions. Under the proposed rule, swap dealers could apply instead for a new "limited risk management exemption" for positions held outside the spot month. The proposed swap dealer exemption would be limited to twice an applicable all-months-combined or single non-spot month speculative position limit. Further, traders would be required to aggregate positions held as swap dealer risk management transactions with net speculative positions for the purpose of determining compliance with the proposed Federal speculative position limits. As with *bona fide* hedgers that hold positions in excess of the proposed limits, swap dealers holding large positions pursuant to the proposed swap dealer exemption would be unable to also take on positions as speculators.

The swap dealer exemption would be administered by the CFTC. Swap dealers would be required to apply to the CFTC for the exemption and update their applications on an annual basis; maintain books and records relating to their swap dealing activities (including transaction data) in order to substantiate the need to offset swap agreement risks through the use of futures, and make such records (including a list of swap counterparties) available to the CFTC upon request; and provide the CFTC with regular reports on the positions that they are hedging. The names of swap dealers that received these exemptions would be made known to the public after a six-month lag.

C. Aggregation

The proposed rule would aggregate positions by ownership in a manner similar to that already required by CFTC rules. Specifically, the proposed rule would apply limits to all positions in which any person has an ownership interest of 10 percent or greater (as well as to positions held by two or more persons acting pursuant to an agreement or understanding, whether express or implied). The proposed rule would provide, however, a limited exemption from this treatment for positions in commodity pools in which the trader has an ownership or equity interest that is less than 25 percent unless that trader actually controls the trading done by that pool. These provisions are similar to existing rules.

However, the proposal would considerably expand aggregation at the controller level. Unlike current aggregation policy for agricultural contracts, the proposed energy limits would not permit positions held by eligible entities such as mutual funds, CPOs, CTAs, or FCMs, to be disaggregated pursuant to the independent account controller framework established in accordance Part 150 of the CFTC's rules. In practical terms, this means that entities such as FCMs would not be permitted to disaggregate positions that are controlled by different divisions of the firm. The rationale for this change, according to the CFTC, is that such exceptions may be incompatible with the proposed Federal speculative position limit framework.

These expanded aggregation requirements at the ownership level reinforce an important stated objective of the proposed rules—to establish a framework that also aggregates across economically similar contracts and multiple reporting markets.

III. Rationale for Regulation

As further discussed below, position limits have historically served two general purposes. The broad purpose, which is associated with the goal expressed in the CEA and serves as the rationale for Federal limits for enumerated agricultural commodities, is to curb or prevent "sudden or unreasonable fluctuations" or "unwarranted changes" in commodity prices. The more narrow purpose, which is associated with exchange-set limits, is to curb or prevent manipulation or congestion.

In recent years, calls for the imposition of tighter standards upon energy derivatives have been premised on the view that speculation in those derivatives, including trading by swap dealers and investments by passive index funds, was responsible for the rise of the price of energy products. **This view, however, has not been confirmed by empirical evidence.** Indeed, a study by CFTC economists issued in 2008 made the politically inconvenient finding that oil prices rose inversely to swap dealer and index fund activity in energy derivatives. *See Staff Report on Commodity Swap Dealers & Index Traders with Commission Recommendations, CFTC, Sep. 2008*. In response to this report, at least one commissioner at the CFTC, Bart Chilton, argued that the CFTC analysis was based on "deeply flawed data," and announced that the CFTC would issue "a more-thorough analysis" regarding the role of speculators in the energy derivatives markets that would "reverse" the agency's earlier findings. *See Ianthe Jeanne Dugan & Alistair MacDonald, Traders Blamed for Oil Spike, Wall St. J., July 28, 2009*. However, the timing announced for this release—August 2009—came and went with no such report ever being issued.

Instead, it appears that the agency has abandoned the notion that the purpose of position limits is to address an actual current or past problem in the marketplace. In other words, it appears that the original rationale for regulation—that energy derivatives had artificially inflated the price of oil—has been abandoned (and a new one adopted in its place) because it could not be proved. In fact, the

CFTC points out that its NPR "does not speak to whether there was excessive speculation in the regulated derivatives market for the major energy commodities." Rather, the agency and its chairman cite the CEA for authority that the statute authorizes the CFTC "to impose speculative position limits **prophylactically.**" (emphasis added). This means, according to the CFTC, that it "need not demonstrate that there has been excessive speculation in the regulated derivatives markets for the major energy commodities" – but only that there might be.[11]

Very significantly from a policy perspective, the CFTC Chairman asserted that position limits serve not just to limit "the burdens of excessive speculation," but also to limit the influence of "positions of large concentration." The agency's General Counsel, Dan Berkovitz, argued that limits serve to promote "diversity and balance in the market," and to ensure that "no one trader has undue influence." The emphasis on "concentration of large positions," suggests a preoccupation with the distribution of participants in the marketplace as the NPR makes clear, something that traditionally has not been the focus of regulatory bodies outside of the antitrust authorities.[12]

Effects If Adopted

Immediate Effects on Regulated Entities

From the perspective of a commodity pool, CPO, CTA or FCM, and from the perspective of those participating in the swaps markets, the CFTC's proposal could have been worse, much worse. If the CFTC estimates are valid, the rule as currently proposed will directly affect only a handful of energy traders, a result of an open-interest formula that is not as restrictive as had been feared.

In addition, the proposal currently does not propose to directly regulate the positions of passive long traders, such as ETFs and index funds, though it asks for public comment on whether it should. It does not extend beyond contracts in the energy sector, though it asks whether it should include precious metals.

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[11] Thus, the Commission apparently believes, as Professor Craig Pirrong points out, that "it is perfectly acceptable to act against the purely hypothetical possibility that . . . [speculation] might [distort markets] in the future–even though the logical and empirical basis for the hypothetical is extremely dubious, at best.".

[12] This focus on participant distribution is illustrated in the discussion of the open interest formula in the CFTC Proposal. According to the CFTC Proposal, if a position limit was set at 10 percent of open interest of 1,000 contracts, but there were only 9 traders on either side of the market, "then at least one trader would necessarily hold more than 100 contracts . . . [and] [t]hat trader would hold such positions in violation of the contract's position limit." *See 75 Fed. Reg. at 4152*. It is also illustrated in the following question that the CFTC submits for public comment: "If passive long positions should be limited in the aggregate, would it be feasible for the Commission to *apportion market space amongst various traders* that wish to establish passive long positions?" *Id. at 4163* (emphasis added).

Moreover, while the proposed rule as noted does not directly affect passive institutional investors, the CFTC's more aggressive posture with respect to positions held by such entities in the energy complex has already had an impact upon at least one of them, the United Natural Gas Fund LP, which announced that it had to reduce its holdings and that it may need to seek alternative investments to compensate for this move in order to adhere to new limits imposed by the exchanges at the behest of the CFTC. *See UNG Fund Says Cuts Natgas Position Due CFTC Moves, Reuters, July 29, 2009*.

The most immediate impact of this proposal on commodity pools (including for this purpose hedge funds) pertains to aggregation with respect to 1) products and 2) ownership. As for the first, the proposed rule would sweep together, at least for the first tier category, economically similar energy contracts that trade on different venues and that settle in different fashions. As for the second, it would severely restrict the ability of pools, CPOs, CTAs and swaps dealers to disaggregate their holdings. In either case, the new policy would be significantly stricter than the current CFTC policy regarding aggregation.

Immediate Effects on the Markets

The proposal should have a number of indirect effects on entities that invest in, or trade, energy assets or contracts. For example, the NPR acknowledges that such limits "could cause **unintended consequences by decreasing liquidity in the markets** for the referenced energy contracts, impairing the price discovery process in these markets, and pushing large positions to trading venues over which the Commission has no direct regulatory authority" (emphasis supplied). *75 Fed. Reg. at 4164*. Other proposals, while not directly aimed at pool investors, would nevertheless affect them. For example, the more aggressive agency stance with respect to swap dealer exemptions could affect the ability of such dealers to enter into energy commodity swaps, which in turn, could "have a direct impact on the ability of institutional investors to access these markets."[13] *See Joanne Morrison, Position Limits Start to Bite, Futures Industry Magazine, Nov. 2009, at 45.*

Finally, while the proposed rule is intended to accommodate the risk management needs of large commercial users, it could prevent such firms from expressing an affirmative viewpoint in the market by engaging in what the CFTC would define as speculative transactions in addition to those associated with their hedging positions. (A commercial firm that had hedges that exceeded the position limits would be prohibited from entering into any speculative transactions.) To the extent

[13] Though it should be noted that the CFTC Proposal does ask for public comment on the feasibility of a "look-through" exemption for swap dealers such that dealers would receive exemptions for positions offsetting risks resulting from swap agreements opposite counterparties who would have been entitled to a hedge exemption if they had hedged their exposure directly in the futures markets. *See 75 Fed. Reg. at 4163.*

the rule has such an impact upon such commercial entities—in effect, preventing their informed voice from being heard—it could have a significant and adverse impact upon price discovery.

Effect on Exchanges

To the extent that the federal government will be largely supplanting the judgments of the contract markets, the ability of those markets to adjust position sizes as circumstances change will be diminished. Although the CFTC boasts that its new framework will allow for positions to be based upon objective formulation, rather than the exercise of agency discretion through periodic rulemaking, the fact remains that as proposed, any changes will take place no more frequently than a period of a year. The proposal should also be viewed in the context of an agency that proclaims its authority to impose such regulatory tools "prophylactically," while at the same time presaging this proposal by revoking no-action relief that had previously been granted to two institutional investors.[14]

Long Term Direction and Long Arm Reach

The proposed rulemaking may be viewed as a harbinger of stricter limits, on more products, with potentially broader jurisdictional reach. This is not simply an obvious deduction from the stated intentions of the proposal's two leading proponents—Chairman Gensler and Commissioner Bart Chilton—who favor much stricter limits across all markets. Rather, it appears that the limits were initially being set at a level that would affect only a limited number of market participants to appease those concerned that a more strict regimen would simply drive business to less transparent venues in the over-the-counter space, or off shore.

That said, Chairman Gensler and Commissioner Chilton, along with at least two other commissioners—Dunn and Sommers—also favor legislation to give the CFTC the legal authority to set limits on those venues that are currently outside its jurisdiction (though it is not obvious how the CFTC would be able to do so for foreign markets, directly at least, in light of a rather inconvenient clause in the CEA that proscribes the agency from adopting any rule or regulation that "governs in any way any rule or contract term or action of any foreign board of trade"). If Congress ever does grant the agency this authority, the open-interest formula could easily—and would likely—be amended to ratchet down the "outer bound" limits to levels that would begin to affect numerous other market participants.

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[14] *See CFTC Release: 5695-0, CFTC Withdraws Two No-Action Letters Granting Relief from Federal Speculative Position Limits on Soybeans, Corn and Wheat Contracts, Aug. 19, 2009* (withdrawing two no-action letters that provided relief from federal agricultural speculative positions limits for DB Commodity Services LLC, a CPO and CTA, that had permitted the DB Commodity Index Tracking Master Fund to take positions in corn and wheat futures that exceed federal speculative position limits).

V. Views of the Commissioners

As mentioned previously, generally rule proposals of the CFTC are issued without the accompaniment of a publicly-held meeting. The fact that the Commission held one here is significant. Fanfare aside, although the Commission voted to release the proposed rule for public comment, from a political perspective at least, the four-to-one vote does not signify final approval, since three commissioners—a majority—expressed reservations with the proposal in its current form. But only one of those commissioners, Republican Scott O'Malia (the newest member of the CFTC) expressed reservations regarding the substantive merits of the proposed rulemaking, pointing out that position limits on agricultural commodities—by which the proposed energy limits are modeled after—did not appear to have any influence on prices in that sector.

Indeed, O'Malia argued that the model on agricultural limits "forces us to ask whether they [and presumably the limits proposed for energy contracts] are effective." Nevertheless, Commissioner O'Malia also joined in the reservations expressed by Commissioner Michael Dunn, a Democrat, and Commissioner Jill Sommers, a Republican, who voiced concerns that the proposal in its current form would lead to migration to less transparent markets in the absence of additional legislative authority for the CFTC over such markets. When seen in this light, there appear to be at least four members of the current Commission who favor enhancing the CFTC's position limit authority by rulemaking and extending it to non-agricultural commodities such as energy, though two would likely be in favor of delaying such action until the agency is given express statutory authority to impose limits over over-the-counter derivatives and contracts offered by foreign boards of trade to U.S. customers.

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