1996-SE-003433

DEPARTMENT OF THE TREASURY
WASHINGTON

UNDER SECRETARY

May 9, 1996

Memorandum for Secretary Rubin

From: John D. Hawke, Jr.

Subject: Chairman Greenspan statements on SAIF

I thought you would be interested in seeing the views on SAIF being attributed to Chairman Greenspan. They are quite inconsistent with what he has testified to, as indicated on the attached set of excerpts.

cc: Sylvia Mathews
Ben Nye
Michael Barr

JAY DICKEY
APPROPRIATIONS

Congress of the United States
House of Representatives

May 6, 1996

Rep. Sam Johnson
1030 Longworth HOB
Washington, D.C. 20515

Dear Sam:

While we were successful in keeping the BIF/SAIF/FICO language off of the conference report to the Omnibus Appropriations Act (H.R. 3019), you know that there is consideration being given to combining the repeal of a portion of the federal gas tax with the BIF/SAIF/FICO tax on banks and bank customers. Much of the argument made for pursuing such a course is that there is an immediate crisis facing the S & L insurance fund.

I want you to know that after we sent our April 16 letter on BIF/SAIF/FICO to the Speaker, I spoke to Federal Reserve Board Chairman Alan Greenspan about the SAIF fund. Chairman Greenspan told me that the SAIF fund is not in as bad a shape as originally thought; and that he agreed that there was an unfairness involved in the BIF/SAIF solution. He also agrees that this proposal is unfair to banks.

I wanted you to know that the Fed Chairman admits that the crisis with SAIF is a potential problem, not immediate. Chairman Greenspan also agrees that the most desirable course would be to resolve all the issues in one piece of legislation.

I am sending another letter around to express our opposition to adding this bank tax to the gas tax repeal to give Congress time to do this right. Please join me in signing it.

Sincerely yours,

Jay Dickey

Quotes from Chairman Greenspan on the SAIF Issue

"It is one of the few things that the Congress can really solve, and you're not solving it. And I think that's why you're getting sort of a level of frustration amongst the four [regulators]. . . . <u>[T]he original SAIF solution approved by the House and Senate should be resubmitted for a vote as quickly as possible.</u>" *(March 19 Testimony before the House Banking Committee.)* (Emphasis added.)

* * *

"I continue to share the concerns [about SAIF] outlined by my colleagues, and <u>I believe that Congress should address these issues in the near term.</u>" *(March 4, 1996 Letter to Representative LaFalce p.1.)* (Emphasis added.)

* * *

"Given the large financial gains to SAIF institutions if they move deposits to BIF, the current deposit insurance system will impose a large deadweight loss on the financial system." *(March 4, 1996 Letter to Representative LaFalce p.2.)*

* * *

"I agree with my colleagues at the Treasury Department, the FDIC, and the OTS that <u>legislation that accomplishes these goals is needed promptly.</u>" *(March 4, 1996 Letter to Representative LaFalce p.3.)* (Emphasis added.)

* * *

"There are several variations of the bill structure and timing implementation that would effectively resolve the current difficulties affecting our deposit insurance system., The bill before you is one of them." *(September 21, 1995 Testimony before the House Banking Committee's Subcommittee on Financial Institutions p.4.)*

* * *

"[I]t is critical to underline that even if there were no evolving problem with SAIF, <u>the existing deposit insurance system, with its reliance on two funds, is inherently unstable.</u>" *(August 2, 1995 Testimony before the before the House Banking Committee's Subcommittee on Financial Institutions p.2.)* (Emphasis added.)

* * *

"[H]aving two deposit insurance funds creates a mechanism that is prone to instability now, and probably in the future. Today, the problem is at the SAIF; it may, at some

date in the future, be at the BIF." *(August 2, 1995 Testimony before the before the House Banking Committee's Subcommittee on Financial Institutions p.3.)*

* * *

" . . . [P]ayments of FICO bond interest funded by SAIF could be put in jeopardy in the very near future. If action is not taken shortly, a future congressional appropriation for interest on FICO bonds might be required, or further increases in SAIF premiums . . ., or possibly even the imposition of higher premiums on both SAIF and BIF deposits . . ." *(August 2, 1995 Testimony before the before the House Banking Committee's Subcommittee on Financial Institutions p.5.)* (Emphasis added.)

* * *

"Invariably, when you get a fixed formula such as PAYGO or various different types of evaluations of how to score a particular program, there's always going to be one, two or three percent of them which fall out and are very clearly aberrations and for which the Congress had no intention of creating a result or a CBO, for example, would score them.

This is one of them. It makes no sense to look at a structure of either a free-standing bill or under reconciliation and to argue that this increases the budget deficit. It makes no sense if in fact that's the way the score is made at CBO as indeed it is in a free- standing bill because they have a list of one, two, three, four, five, six -- then the scoring is wrong.

And there is an opening here because it's -- I gather it's a majority of the House and 60 votes of the Senate which enables one to override this. If I ever saw a case where that is appropriate, this is it.

Years ago, our grave concern is that everything which would come before the budget Committees or the floors of the House and the Senate would very easily get an override. Fortunately, it's turned out not to be case and therefore PAYGO has been successful. But let's recognize that the original purpose of the act was to in fact leave some leeway for the unusual case." *(March 19 Testimony before the House Banking Committee.)*

1996-SE-003793

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

May 15, 1996

MEMORANDUM FOR **SECRETARY RUBIN**

THROUGH: John D. Hawke
Under Secretary for Domestic Finance

FROM: Richard S. Carnell RSC
Assistant Secretary
Financial Institutions

SUBJECT: The Effect of SAIF Deposit Migration on BIF

Failure to resolve the problems of the Savings Association Insurance Fund (SAIF) would have direct financial consequences for banks and the Bank Insurance Fund (BIF). A large, long-term premium differential would give thrifts and banks strong incentives to shrink their SAIF-insured deposits. Companies owning thrifts can establish BIF-insured bank affiliates -- or use existing ones -- to encourage depositors to move their funds from SAIF-insured to BIF-insured institutions. (Roughly 100 SAIF-member institutions, with about $150 billion in SAIF-assessable deposits, already have such affiliates or applications pending to establish them.)

Because insurance fund reserves do not migrate along with deposits, deposit migration will dilute BIF -- i.e., reduce its ratio of reserves to insured deposits. Each $100 of insured deposits migrating to BIF will require $1.25 in BIF reserves.

Under the proposed SAIF legislation, BIF-insured institutions would pay just over $600 million annually toward FICO payments, based on the current size of BIF's and SAIF's deposit base. Without a SAIF solution, deposit migration from SAIF to BIF could, in the short term, impose *greater* annual costs on BIF members. Even if only $50 billion of SAIF-insured deposits migrated to BIF, BIF would face a dilution cost of $625 million. And $50 billion represents just 7 percent of SAIF's current deposit base. Annual deposit migration could easily exceed that amount over the next few years if the bipartisan solution fails to become law.

As of year-end 1995, BIF held $1.30 per $100 of insured deposits. A $50 billion increase in BIF-insured deposits would reduce this amount to $1.27, other factors equal. If $84 billion in deposits migrated from SAIF to BIF (an 11 percent reduction in SAIF's deposit base), BIF's reserves would decline to $1.25 per $100 of insured deposits. Thus dilution would entirely consume a reserve cushion that (in the near term) shields banks from future premium increases. Such increases could result from continued deposit migration, greater reliance by banks on insured deposits as a funding source, or an increase in expected deposit insurance losses.

2000-SE-008250

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

August 11, 2000

ASSISTANT SECRETARY

INFORMATION

MEMORANDUM FOR SECRETARY SUMMERS
DEPUTY SECRETARY EIZENSTAT
UNDER SECRETARY GENSLER

FROM: Gregory A. Baer
Assistant Secretary for Financial Institutions

SUBJECT: FDIC "Options" Paper on Deposit Insurance Reform

On August 9, the Federal Deposit Insurance Corporation (FDIC) released an "options" paper on reforming the deposit insurance system. The FDIC believes that, because the banking and thrift industries have never been healthier, now is the time to address the flaws in the current system. Existing restrictions on the FDIC's authority to set premiums have resulted in over 90 percent of banks and thrifts currently paying no premiums at all. These institutions can rapidly expand their insured deposits without paying anything to the FDIC. On the other hand, should adverse economic conditions cause bank failures to increase and the insurance fund to fall below 1.25 percent of insured deposits, existing rules would impose a high premium rate (generally a minimum of 23 cents per $100 of domestic deposits). This could curtail lending at a time when loans are most needed.

The paper does not make recommendations, except to merge the bank and thrift insurance funds. It discusses alternative approaches for how the FDIC should set premiums to reflect risks posed by individual banks and thrifts, and for how deposit insurance financing in the aggregate should be structured. It also raises the question of whether the current insurance coverage limit of $100,000 should be increased. The FDIC is soliciting comments on the "options" paper throughout the fall and has stated that it hopes to offer recommendations for reform around year-end.

Pricing Risks: The paper discusses the merits of using various supervisory and market indicators to set risk-based premiums. (The current risk-based premium matrix considers only capital ratios – generally considered a lagging indicator of problems – and the institution's supervisory rating.) Most approaches that would significantly improve the risk sensitivity of premiums would require new legislation.

Deposit Insurance Financing Structure: The paper describes two general approaches for reforming the overall financing structure. One would be a user fee approach, under which banks would pay for the deposit insurance benefit provided by the Government without expectation of a return on, or return of, any funds contributed. Premiums could be relatively stable – set to match expected losses and revenues over a long period – or they could be adjusted more frequently in order to meet a target fund reserve ratio. The other approach – a mutual approach – to deposit insurance financing would allow for rebates if the insurance fund exceeded a certain threshold. It might also allow for explicit bank ownership claims on insurance fund resources, similar to the current credit union insurance structure.

Contrary to the American Banker headlines, the paper had relatively little to say about systemic risk and "too-big-to-fail" treatment. It suggested as one possibility that deposit insurance funding should be completely separated from systemic risk funding issues (i.e., the possible need to provide some protection to uninsured liabilities in a large institution failure). Yet it did not explicitly discuss the role of the U.S. Treasury in providing "full faith and credit" support for deposit insurance. Some reform proponents have argued that the industry or the deposit insurer should explicitly compensate the Treasury in return for providing catastrophic coverage to the deposit insurance fund.

Coverage Limit: While professing neutrality, the discussion in our view seems somewhat sympathetic to arguments for increasing the coverage limit. FDIC argues that the trade-off between increasing moral hazard and raising the insurance coverage limit should not be considered in isolation -- better pricing of deposit insurance may make the level of coverage an issue of secondary importance. The paper raises doubts that hiking the limit above $100,000 would significantly raise aggregate insured deposits and thus increase moral hazard. It asks whether $100,000 is sufficient for certain elderly depositors with serious medical care needs. It shows how coverage relative to per capita income has dramatically declined over time. And it notes the increasing difficulties that small banks have in competing for funds. It suggests that in the absence of an increase in coverage, small banks will be likely to rely more on Federal Home Loan Bank advances, which – because of their secured status – also raise the FDIC's risk exposure.

ADMINISTRATION HISTORY APPENDIX
CHAPTER THREE: IMPROVING FINANCIAL SERVICES, AND MARKETS AND THE FEDERAL GOVERNMENT'S FINANCIAL MANAGEMENT

DERIVATIVES

1998-SE-013673

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

December 3, 1998

INFORMATION

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

THROUGH: John D. Hawke, Jr.
Under Secretary (Domestic Finance)

Gary Gensler
Assistant Secretary (Financial Markets)

FROM: Edward S. Knight ESK
General Counsel

Roger L. Anderson RLA
Deputy Assistant Secretary (Federal Finance)

SUBJECT: Legal Certainty Issues Associated with Over-the-Counter Derivatives

We are attaching a "white paper" that provides background on legal certainty issues associated with over-the-counter (OTC) derivatives. The paper also includes current Treasury staff recommendations for addressing these issues, which are consistent with (but in some cases, more detailed than) the public positions that Treasury has taken in the past.

Although the topics discussed in the paper will not be on the agenda for the December 7 meeting of the President's Working Group on Financial Markets, it is likely that they will be addressed in the testimony of Roger Anderson and representatives of other Working Group agencies before the Senate Agriculture Committee on December 16. In addition, these issues will inevitably play a prominent role in the OTC derivatives study that the Working Group is preparing.

Let us know if you would like to have a meeting to discuss the issues raised in the paper.

Introduction

The Commodity Exchange Act (the "CEA") vests the Commodity Futures Trading Commission (the "CFTC") with "exclusive jurisdiction" over commodity futures and options, and outlaws all commodity futures and options transactions that are not conducted in accordance with the CEA and the regulations promulgated by the CFTC. As a result, certainty about the legal status of transactions that may fall within the scope of the CEA -- such as over-the-counter ("OTC") derivatives -- is extremely important since a transaction that is premised on an understanding of the law that is subsequently rejected by the courts could be unenforceable. Legal uncertainty of this nature presents systemic risk issues, because parties to classes of transactions that were found to be unenforceable could repudiate their obligations. Legal uncertainty may also inhibit the development of risk-reducing systems, such as clearinghouses, because the regulatory regime to which such systems may be subject is uncertain.

The proposals discussed below are aimed at reducing legal uncertainty in the OTC derivatives markets. They reflect a judgment that the CEA is, in most cases, unsuited to the regulation of these markets. However, proposals to enhance legal certainty by excluding certain derivative transactions or market participants from the CEA are not at odds with proposals to enhance oversight by other agencies of the derivatives activities of banks, broker/dealers, and their affiliates. Rather, the overall goal of these proposals is to insure that regulation is clear in scope and appropriate to the characteristics of the markets.

I. Swap Exemption and Hybrid Instrument Rule

Current Law. In 1989, the CFTC issued a Policy Statement Concerning Swap Transactions (the "Policy Statement"), which reflected the agency's view at that time that "most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the [CEA] and regulations." At that time, the CFTC lacked the authority to exempt futures contracts from the exchange-trading requirement of the CEA, so market participants understood the Policy Statement as a determination by the CFTC that "most" swaps are not within the scope of the CEA (i.e., they are not commodity futures or options).[1]

In 1992, Congress amended the CEA to give the CFTC authority to exempt transactions from all provisions of the CEA except a provision that codified an agreement between the CFTC and the Securities and Exchange Commission (the "SEC") about the respective jurisdiction of those

[1] The CFTC did have exemptive authority for commodity options at that time, but the Policy Statement did not purport to exercise this authority with respect to options.

agencies (known as the "Shad-Johnson Accord").[2] Congress also indicated that the CFTC should use its authority to exempt swaps from the CEA "to the extent that such agreements may be regarded as subject to the provisions of [the CEA]." 7 U.S.C. § 6. In other words, Congress indicated that swaps should not be regulated under the CEA, but did not clearly establish that swaps are commodity futures or options that would be subject to the CEA in the absence of an exemption.[3]

In 1993, the CFTC adopted the Swap Exemption, which exempts certain swap agreements from all provisions of the CEA except the Shad-Johnson Accord and the CEA's anti-fraud provisions. 17 C.F.R. pt. 35.[4] The limitations on the scope of the Swap Exemption are implicitly at odds with the apparent rationale for the Policy Statement, since swaps could not be subject to the CEA's anti-fraud provisions unless they actually are commodity futures or options.

A swap agreement must meet the following criteria to fall within the scope of the Swap Exemption:

(1) The swap agreement must be entered into between eligible swap participants. "Eligible swap participants" are defined to include various regulated financial institutions, business enterprises that meet certain tests relating to total assets or net worth, certain pension funds, state and local governments, and individuals with more than $10 million in total assets.

(2) The swap agreement may not be part of a fungible class of agreements that are standardized as to their material economic terms.

(3) The creditworthiness of the parties to the swap agreement must be a material consideration in entering into and determining the terms of the swap agreement.

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2 The consequences of the Shad-Johnson Accord are discussed further in Section II below.

3 Congress also enacted a similar provision authorizing the exemption of "classes of hybrid instruments that are predominantly securities or depository instruments." Id.

4 The CFTC also adopted its Hybrid Instrument Rule, which exempts securities and bank deposits that have some of the characteristics of commodity futures or options from all of the provisions of the CEA except the Shad-Johnson Accord. 17 C.F.R. pt. 34. To qualify for the exemption, a hybrid instrument must derive more than 50% of its value (as determined by a calculation methodology specified in the exemption) from aspects of the instrument that are not related to the value of commodities, must be subject to securities or banking laws and sold to persons eligible to purchase the instrument under such laws, and must satisfy certain criteria regarding marketing, payment terms, and settlement.

(4) The swap agreement may not be entered into and traded on or through a multilateral transaction execution facility.

Reason for Change. The Swap Exemption has been only partially successful in alleviating legal uncertainty in the swaps market. Earlier this year, the CFTC published a "Concept Release" that requested comment on whether the Swap Exemption should be amended to provide that market participants must comply with more rigorous requirements to be eligible for the exemption. Because it has never been conclusively determined that swap agreements are in fact commodity futures or options, it is not clear that the CFTC can impose any restrictions on the market (including those found in the current Swap Exemption).

In effect, the Concept Release attempts to turn the purpose of the law that authorized exemption of the swaps market on its head, by suggesting that the CFTC can use its exemptive authority to craft a regulatory scheme. In the absence of further Congressional action, this effort lacks legitimacy, and the agency's authority would likely be challenged by market participants in court. Such litigation could result in an incoherent regulatory framework, in which certain types of swaps are held to be futures or options that must comply with CFTC regulations in order to be enforceable, while other types of swaps are held to be entirely excluded from the CFTC's jurisdiction. Many have expressed the view that the markets in question are too large and important to be subject to this sort of legal uncertainty.[5]

In addition, the Swap Exemption itself has several ambiguities that should be resolved. First, swap agreements have become increasingly standardized over time, as a natural result of the maturing of these markets. There is concern that the CFTC or a court may determine that certain types of swaps do not meet the requirement that swaps must not be part of a fungible class of agreements that are standardized as to their material economic terms. If the swaps are also found to be commodity futures or options, it follows that they are illegal and unenforceable (unless some other exemption from the CEA, such as the trade option exemption, is available).

Second, the term "multilateral transaction execution facility" is not defined in the Swap Exemption. However, the CFTC has explained that the term refers to a physical or electronic facility that links market participants simultaneously with the capability of entering into binding contracts among themselves. As a result, there is a concern that the CFTC or a court may determine that the use of screen-based trading systems that match swap counterparties, or

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[5] The Concept Release also sought comment on whether the Hybrid Instrument Rule should be amended, thereby raising similar questions as to the CFTC's authority. The Hybrid Instrument Rule is premised on the view that instruments qualifying for the exemption are subject to regulation by the SEC or bank regulatory agencies. Because the CEA gives the CFTC "exclusive jurisdiction" over futures and options, an assertion by the CFTC of regulatory authority over hybrid instruments would raise questions about the authority of other agencies to regulate these instruments.

clearinghouses that net counterparties obligations, would make swaps subject to the CEA because they increase the similarity between swaps and comparable exchange-traded futures or options.

Proposal. Treasury staff proposes that Congress amend the CEA to exclude qualified swap agreements from the CEA.[6] An exclusion from the CEA is preferable to the current exemption, because it would eliminate uncertainty about the effect of CFTC regulatory action on these markets. The proposed exclusion would conclusively establish that swaps that qualify for the exclusion are not covered by the CEA.[7]

The exclusion would retain some of the requirements of the current Swap Exemption. Transactions would qualify only if conducted between appropriate persons. The requirement that creditworthiness of counterparties be a material consideration would also be retained, to insure that swaps qualifying for the exclusion are not fungible instruments that compete directly with exchange-traded instruments.[8] However, the limitation on standardized terms would be eliminated, since it creates uncertainty as to the scope of the exclusion while adding little to the limitation on fungibility that is implicit in the requirement for consideration of credit risk.

Finally, the limitations on transactions conducted through multilateral transaction execution facilities would be replaced by a requirement that transactions not occur through an "organized futures exchange." An organized futures exchange would be defined in the statute to include recognized futures and options exchanges, securities exchanges and securities associations, and anything functionally equivalent to a recognized exchange. The definition of functional equivalency would focus on the main attributes of current futures and securities exchanges, including the potential for participation by the general public, the ability to make trades for the account of customers, and the availability of all bids and offers to all persons doing business through the facility. The definition would exclude clearinghouses and electronic screen-based trading systems.[9]

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[6] This proposal is consistent with the position taken by Treasury in debate about the CEA last year.

[7] Treasury staff also proposes codifying the Hybrid Instrument Rule as an exclusion of covered instruments from the CEA. Although the Hybrid Instrument Rule does not raise as many legal certainty issues as the Swap Exemption, an exclusion would resolve questions about the CFTC's authority to qualify an exemption by imposing greater restrictions, and would clarify that other laws (such as securities or banking laws) may apply to such instruments.

[8] We note that keeping the creditworthiness requirement would impose limits on how any potential swaps clearinghouses are structured.

[9] The regulation of screen-based trading systems and clearinghouses is discussed in Sections IV and V below.

II. Swaps and Futures on Non-Exempt Securities

Current Law and Reason for Change. The Shad-Johnson Accord prohibits futures on securities other than (1) securities that are exempt from the securities laws or (2) broadly-based security indices. Moreover, the CFTC cannot provide exemptions from this restriction, since the agency's exemptive authority does not extend to the provisions of the Shad-Johnson Accord. Thus, to the extent that a swap involving a security that is not exempt from the securities laws (a "non-exempt security"), such as an equity swap, a credit swap, or an emerging market swap, is deemed to be a commodity futures contract, it would be illegal, and the Swap Exemption would not (and could not) protect it.

Swap markets in these instruments have developed, however, due to the CFTC's statements in the Policy Statement that "most" swaps are not appropriately regulated as commodity futures or options. The CFTC's Concept Release greatly unsettled these markets, because statements implying that swaps might be viewed as futures were tantamount to saying that swaps in non-exempt securities might be illegal. Legislation enacted as part of this year's Omnibus Appropriations Act temporarily alleviated this problem to some extent by freezing until March 30, 1999, the pre-existing legal status of swaps entered into in reliance on the Policy Statement (but without actually clarifying what that legal status is).

Proposal. Treasury staff proposes including swaps on non-exempt securities within the scope of the exclusion from the CEA discussed above.[10] This change in the law would clarify that these swaps are entitled to the same legal status as other swaps if they fall within the terms of the exclusion. Because swaps on non-exempt securities can be used as substitutes for direct investments in securities, however, they would be subject to the anti-fraud jurisdiction of the SEC (and possibly other provisions of the securities laws). Thus, these markets would benefit from greater legal certainty, but would be subject to regulation.

Treasury staff also believes that consideration should be given to repealing the provision of the Shad-Johnson Accord that bans exchange-traded futures on non-exempt securities, and giving the SEC authority to regulate such instruments, in order to address the "level playing field" concerns of futures exchanges.

III. Treasury Amendment: Foreign Currency and Government Securities Derivatives

Current Law. The Treasury Amendment excludes certain derivatives transactions in foreign currency, government securities, and certain other non-physical commodities from the CEA. Although some uncertainty about the scope of the Treasury Amendment was resolved by last

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[10] Again, this is consistent with positions taken by Treasury in the past.

year's Supreme Court decision in CFTC v. Dunn, legal uncertainty continues to revolve around the Treasury Amendment's use of the term "board of trade."

"Board of trade" is defined in the CEA to mean "any exchange or association, whether incorporated or unincorporated, of persons who are engaged in the business of buying or selling any commodity or receiving the same for sale on consignment." 7 U.S.C. § 1a. The term has two important functions in the CEA: First, it is used in the provisions of the CEA and CFTC regulations that require any commodity futures or options transaction to be conducted on a "board of trade which has been designated by the Commission as a 'contract market'." Thus, futures and options trading in a particular commodity may occur only on a board of trade that has effectively been licensed by the CFTC for that purpose. Second, the term "board of trade" is used to limit the scope of the Treasury Amendment: transactions involving Treasury Amendment products (such as foreign currency and government securities) are excluded from the CEA unless conducted on a board of trade.

Reason for Change. The Treasury Amendment is a statutory exclusion that provides one of the legal legs on which the OTC market rests. The "board of trade" clause of the Treasury Amendment limits the exclusion. A clear understanding of "board of trade" in the Treasury Amendment is therefore critical for determining which transactions are not subject to CFTC jurisdiction. As defined in the CEA, the term "board of trade" is potentially quite broad. This breadth arguably makes sense for certain provisions of the CEA, such as the provisions that effectively bring all futures and options trading under CFTC jurisdiction. However, as some courts have recognized, this breadth makes no sense at all in the context of the Treasury Amendment. In such a context, in order for the exclusion to have any meaning, any exceptions to it must be narrow and clear.

In light of recent actions, the CFTC appears to have a broad view of the meaning of "board of trade." Courts that have interpreted the term "board of trade" in the context of the Treasury Amendment have generally agreed that Congress could not have intended a literal application of the CEA's definition of that term for the purposes of the Treasury Amendment, since such a reading severely limits, if not obliterates, the scope of the Treasury Amendment. However, the courts are divided over just what the term does mean in that context. One court (the Ninth Circuit) has said that "board of trade" in the Treasury Amendment means "organized futures exchange," while another (a district court in the Second Circuit) has said that term means anything other than the interbank market. Such legal ambiguity chills market innovation and invites further litigation. For example, "board of trade" concerns have been expressed about entities trying to develop communication systems to facilitate trading of foreign currency forwards, and a government securities clearinghouse that is seeking to clear repurchase agreement transactions.[11]

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[11] The debate about the meaning of "board of trade" may be influenced by soon-to-be published SEC rules that will exempt, but not exclude, government securities automated trading systems from a revised regulatory definition of "exchange." If such systems are "exchanges"

Proposal. Last year, Treasury formally proposed that the term "board of trade" in the Treasury Amendment be replaced by the term, "organized futures exchange." See Letter from Secretary Rubin to Chairman Lugar (Feb. 3, 1997) (Tab A). The term would be defined in the manner discussed above in connection with swaps, in order to harmonize the Treasury Amendment exclusion with the swaps exclusion.

IV. Trading Systems

Current Law and Reason for Change. Broker-dealers that sponsor or operate automated systems for receiving or displaying and matching or crossing orders for securities transactions (called "broker-dealer trading systems") are required to register such systems with the SEC, to keep records of participants, transactions and orders, and to file reports with the SEC. The SEC is expected to approve rules on December 2 expanding its regulation of some of these systems. Trading systems for government securities brokers and dealers are not subject to these regulations, but are subject to oversight by Treasury or the federal bank regulatory agencies.

The development of similar trading systems for OTC derivatives has been inhibited by uncertainty about the applicability of the CEA, since a trading system may be deemed to be a "multilateral transaction execution facility" or a "board of trade." Systems that have been developed -- such as government securities derivatives systems operated by inter-dealer government securities brokers, or systems for foreign exchange trading that are based in London but are available to U.S. customers – must evaluate legal risks in making decisions about what products they will trade or how they structure their business.

This issue is further complicated by the views of the traditional futures exchanges, which would consider the development of extensive trading systems for OTC derivatives to be a competitive threat. For several years, these exchanges have lobbied for a relaxation of the CEA that would allow them to develop "professional markets" (also known as "pro markets") – lightly regulated futures exchanges that are open only to sophisticated investors – in order to compete more effectively with OTC markets.

Proposal. As discussed above, Treasury staff recommends that the terms "multilateral transaction execution facility" in the Swap Exemption and "board of trade" in the Treasury Amendment be replaced by a new defined term, "organized futures exchange." In the drafting of this definition, particular attention would be given to clarifying the status of trading systems.[12]

(albeit exempted ones) for purposes of the securities laws, the CFTC may argue that they are also "boards of trade" when they trade derivatives.

[12] This proposal is similar to positions that Treasury has taken in the past.

Trading systems for OTC derivatives would not be organized futures exchanges if they met certain "safe harbor" criteria, such as limiting their trading to non-physical commodities (i.e., commodities other than agricultural or mineral products) and limiting system access to sophisticated parties trading as principals. As a result, trading systems meeting these standards would not be subject to direct regulation, since the participants in the markets would not need government assistance to protect their interests. As described below, however, clearinghouses associated with trading facilities would be regulated to address systemic risk concerns. In order to provide "pro market" relief to futures exchanges, the proposal would clarify that futures exchanges could establish affiliates that would qualify for the safe harbor. This is significantly less "relief" than the exchanges have sought, but we believe that it should be appealing to them as an approach to "leveling the playing field."

The proposal would not make any changes to current law with respect to securities trading systems. The proposal would clarify, however, that trading systems for government securities derivatives would be treated like systems for other OTC derivatives on non-physical commodities.

V. Clearinghouses

Current Law.

Futures. Although the CEA does not explicitly give the CFTC authority over commodity futures or option clearinghouses, it is generally settled that the CFTC has the authority to regulate clearing when it is performed by or for a CFTC-designated contract market, even when the clearing is performed by a separately incorporated clearing corporation. CFTC regulations place various requirements on clearing organizations, including requirements for recordkeeping, segregation and investment of customer funds, and submission of rules for CFTC approval. The CFTC also has worked closely with the SEC on cross-margining of futures and securities positions on CFTC- and SEC-regulated exchanges.

The CFTC's authority over the clearing of instruments that are *not* traded on a CFTC-designated contract market is questionable, however, despite the agency's assertions of jurisdiction. In its May 1998 Concept Release, the CFTC stated its belief that the clearing of swaps is not permitted under the Swap Exemption. Presumably the agency would have similar views on clearing facilities for all other instruments that are exempted from the CEA, such as foreign currency. In an October 8, 1998, comment letter on the CFTC's Concept Release, the Foreign Exchange Committee, a group of major domestic and foreign commercial and investment banks and foreign exchange brokers, argued that the CFTC does not have statutory authority to regulate clearing entities that are not connected to a CFTC-regulated exchange or contract market, and that the agency's position created legal uncertainty that caused some of their members to consider moving their business offshore.

In response to CFTC actions, on June 15, 1998, the London Clearing House (LCH) filed a petition for exemptive relief with the CFTC that would permit qualified U.S. entities to use a clearing facility being developed by LCH for interest rate swaps and forward rate agreements. In addition, CLS Services, a U.K. holding company that is developing a foreign exchange clearing facility called the Exchange Clearing House Limited (ECHO), has approached Treasury for a clarification of the application of the CEA to ECHO.

Securities. Unlike the CFTC, the SEC has explicit authority to register and regulate clearing agencies for the clearance and settlement of securities (other than exempt securities) *and* to facilitate the establishment of linked or coordinated facilities for the clearance and settlement of transactions in securities, securities options, futures, options on futures, and commodity options. In exercising this authority, the SEC is required to coordinate with the CFTC and consult with the Federal Reserve.

Reason for Change. The legal uncertainty surrounding the CFTC's authority for the clearing and settlement of financial instruments that are *not* traded on a CFTC-designated contract market has slowed the development of clearing entities for OTC instruments such as swaps and foreign exchange contracts. This uncertainty has unnecessarily retarded the development of systems that can reduce settlement risk and ultimately systemic risk and contribute to the efficient operation of financial markets.

Proposal. Treasury staff recommends seeking legislation that would provide the CFTC with explicit statutory authority to regulate the clearing and settlement *only* of instruments that are traded on CFTC-designated contract markets. Such a proposal also should provide the CFTC with a statutory directive (modeled after the SEC's requirement) to coordinate with the SEC and the Federal Reserve to facilitate the establishment of linked or coordinated facilities for clearance and settlement.

Treasury staff recommends leaving unchanged the SEC's authority to oversee securities clearinghouses.

Finally, for clearinghouses that may develop for interest rate, currency or other types of swaps, foreign exchange, and other financial instruments not explicitly overseen by the SEC or CFTC, we recommend pursuing legislation that would give jurisdiction to the Federal Reserve, as a regulator of such clearinghouses if they do not also clear securities or futures contracts. This should remove the legal uncertainty surrounding the development of swaps and foreign exchange clearing organizations and provide an avenue for reducing systemic risk. Moreover, the allocation of regulatory authority among the CFTC, the SEC and the Federal Reserve would be consistent with the respective jurisdiction of those agencies over products and market participants.

VI. Limits on CFTC Anti-Fraud Authority

Current Law. The CFTC has broad anti-fraud authority that is designed to provide the agency with considerable leeway in addressing unauthorized practices by entities regulated by the CFTC (such as futures commission merchants, introducing brokers, and commodity trading advisors) and those who are not regulated by the agency but who offer or sell products that are subject to the CFTC's jurisdiction. The CFTC currently does not have anti-fraud jurisdiction over transactions covered by the Treasury Amendment, however, unless such transactions are commodity futures or options and are conducted on a "board of trade." As discussed above, the meaning of the term "board of trade" is the subject of considerable uncertainty. Moreover, although the CFTC has asserted that it has anti-fraud authority over swaps, this assertion of authority is legally supportable only if the products in questions actually are commodity futures or options. Since the legal status of these instruments is not clear, the scope of the CFTC's anti-fraud jurisdiction is not clear either.

Reasons for Change. Despite questions about the scope of its authority, the CFTC has actively pursued enforcement actions against foreign exchange "bucket shops" (i.e., unregulated entities that deal with the general public) in which the CFTC contends that the entities are "boards of trade" that are trading illegal futures or options contracts. These enforcement actions have resulted (and will continue to result) in litigation about the meaning of the term "board of trade" that has spillover effects on OTC markets for foreign currency and government securities. The situation creates an undesirable "Catch-22," in which decisions that uphold the authority of the CFTC to pursue fraud may undermine the enforceability of legitimate derivatives transactions in foreign currency and government securities.

The CFTC has not, to date, initiated enforcement actions in the swap market that have tested the agency's assertion of jurisdiction. If such enforcement actions are initiated in the future, however, they are likely to result in litigation that may ultimately be damaging to the markets in question.

Proposal. Last year, Treasury proposed legislation that would give the CFTC specific authority to prosecute fraud by unregulated entities that sell foreign exchange products to retail customers (i.e., "bucket shops"). See Tab A. This proposal would allow the CFTC to pursue these actions without having to litigate questions concerning the agency's authority. However, the legislation would exclude transactions in other Treasury amendment products (including government securities) from CFTC jurisdiction unless they are conducted on an organized futures exchange, since there has been no showing of a need for greater regulation. Many of the products in question are securities (and therefore subject to SEC jurisdiction), and most market participants are either regulated by the SEC or the banking agencies or are sophisticated institutions that are capable of seeking redress for wrongs done to them.

As discussed above, Treasury staff also recommends excluding swaps and hybrid instruments from the CEA. As a result, transactions covered by the exclusion would not be subject to CFTC anti-fraud jurisdiction. In the case of swaps, this result is appropriate because market participants must be "appropriate persons" in order to participate in the market. Persons covered by the definition of "appropriate persons" – such as banks, broker/dealers, large corporations, and high-net worth individuals – do not need government regulation to protect themselves from fraud, and can avail themselves of common law remedies if they have been defrauded. In the case of hybrid instruments, products excluded from the CEA are subject to oversight by the SEC or federal bank regulators.

VII. Exclusive Jurisdiction of the CFTC

Current Law and Reason for Change. The CEA gives the CFTC "exclusive jurisdiction" over commodity futures and options, which means that a transaction that is regulated by the CFTC cannot be regulated by any other federal or state agency. This provision of the CEA has made "turf" disputes between the CFTC and other regulators particularly difficult, since a successful assertion of jurisdiction by the CFTC over a market would divest other regulators of authority over that market. Thus, an assertion of jurisdiction over hybrid instruments would be seen as a challenge to the authority of the SEC and the bank regulatory agencies to instruments that are securities or bank deposits. Similarly, the SEC's recently adopted rules for specialized regulation of OTC derivatives dealers associated with broker/dealers (known as "broker/dealer lite") was challenged by the CFTC as an assault on that agency's supposed exclusive jurisdiction over derivatives.

Proposal. Treasury staff recommends replacing the exclusive jurisdiction clause with a provision that would allow the CEA to preempt state law, but not the authority of other federal regulators.

THE SECRETARY OF THE TREASURY
WASHINGTON

February 3, 1997

The Honorable Richard G. Lugar
Chairman
Committee on Agriculture,
Nutrition and Forestry
United States Senate
Washington, D.C. 20515

Dear Chairman Lugar

The staffs of the Commodity Futures Trading Commission and the Treasury Department have met over the past thirteen months to discuss the policy underlying the provision of the Commodity Exchange Act (CEA) commonly referred to as the "Treasury Amendment." Both agencies agree on the need to clarify the scope of the CFTC's authority to protect retail customers against fraud by entities that are not currently subject to any federal regulation or supervision Unfortunately, Treasury and the CFTC have been unable to reach agreement on the proper approach for achieving this goal and continue to disagree on several key issues During that time, we have also worked to protect the interests of the Department in litigation, including the Dunn case before the Supreme Court This letter will not restate the legal arguments put forward in that context, which are still valid today

The CFTC recently transmitted to you a proposal for changes to the Treasury Amendment Treasury objects to the proposal that the CFTC has offered. Enclosed for your consideration is a Treasury proposal to amend the Treasury Amendment in a way that addresses the retail fraud issue in a clear and direct manner without creating new ambiguities or unnecessarily increasing the regulatory burden of entities already subject to federal regulation

One of the key points of difference between Treasury and the CFTC relates to the treatment of the over-the-counter institutional market for foreign exchange and the other instruments enumerated in the Treasury Amendment Treasury believes this market should be entirely exempt from the CEA, as it is under the current Treasury Amendment The public is well served by deep and liquid foreign exchange markets which provide access to foreign exchange instruments for a wide range of U.S businesses that need to participate in global commerce. Although the CFTC acknowledges that it agrees with Treasury that the "interbank market [should] remain exempt from regulation under the CEA," the draft legislation proposed by the CFTC does not provide an unambiguous exemption for all segments of the over-the-counter institutional markets If enacted, the CFTC's legislation would likely result in additional litigation concerning the scope of exempted activities. Continued uncertainty would have a harmful effect on these important markets and may cause an increasing share of such markets to move overseas. Treasury understands that the staffs of the bank regulatory agencies share its concern about the potentially harmful impact of continued uncertainty in the institutional markets.

Treasury is also concerned that the CFTC's proposal imposes an unwarranted overlay of CFTC jurisdiction on federally regulated entities, such as banks, that may sell Treasury Amendment instruments to small businesses or members of the general public. There is no evidence that existing regulatory structures fail to ensure that there is adequate federal oversight of such transactions. Moreover, we believe that it is unwise to impose additional layers of regulation upon entities that are already under the jurisdiction of one or more federal regulators.

Thank you for your consideration of Treasury's proposal. We continue to discuss these issues with the CFTC and anticipate discussing our proposal with the federal banking agencies and the Securities and Exchange Commission We look forward to working with you and your staff.

Sincerely,

Robert E. Rubin

Treasury Legislative Proposal to Amend the Treasury Amendment

Background

Under the CEA, the CFTC generally is given jurisdiction over contracts for the sale of commodities for future delivery (commonly referred to as futures contracts) and options on commodities. Before 1974, the term "commodity" in the CEA included only tangible agricultural commodities. In 1974, when the CFTC was created, the definition of the term "commodity" was significantly expanded. The new definition was open-ended, encompassing "all services, rights and interests in which contracts for future delivery are presently or in the future dealt in." The concepts of "futures contracts" and "options" remained undefined. The Treasury Department proposed language exempting off-exchange derivative transactions in foreign currency, government securities, and certain other financial instruments from the newly expanded CEA. This exemption was adopted virtually unchanged by Congress and is known as the Treasury Amendment

In proposing the amendment, Treasury's primary concern was to protect the foreign currency market in the United States from potentially harmful regulation. In a letter to the Chairman of the Senate Committee on Agriculture and Forestry, Treasury noted that the foreign currency market "has proved highly efficient in serving the needs of international business in hedging the risks that stem from foreign exchange rate movements" S Rep No. 1131, 93rd Cong., 2d Sess. 50 (1974) Since that market consisted primarily of banks and dealers, Treasury believed that it would be inappropriate for any additional regulation of this complex function to be carried out by the CFTC Treasury argued that granting the CFTC jurisdiction over the foreign currency market would confuse an already highly regulated business sector and that new regulatory limitations and restrictions could have an adverse impact on the usefulness and efficiency of foreign exchange markets for traders and investors For similar reasons, Treasury argued that the CEA should exempt derivative transactions involving government securities and a variety of other financial instruments, unless conducted on organized exchanges

Since the enactment of the Treasury Amendment, the size and importance of the markets for both foreign currency and government securities have increased dramatically. As a result, the goal of the Treasury Amendment, to preserve the efficiency of these markets by avoiding unnecessary regulation and uncertainty, is even more compelling today. Indeed, when it enacted the Government Securities Act of 1986, Congress recognized that unnecessary or inflexible regulation could increase the government's borrowing costs, and it acknowledged the need to preserve both the efficiency and the integrity of that market S Rep No 1416, 99th Cong., 1st Sess. 10 (1985)

Given this dramatic growth in the size of the financial markets since 1974, the open-ended nature of CEA coverage makes it even more crucial that the scope of the exemption from the CEA be absolutely clear However, since the Treasury Amendment's enactment, the scope of CEA coverage has continued to be a troublesome source of legal uncertainty for the financial markets. Determining how to draw the line between instruments that are subject to the CEA and those that are not, in a manner that provides logical consistency and predictability for new instruments, has been difficult under current law.

In the mid-1980's, a greater focus on these issues resulted from various interpretive and rule-making activities of the CFTC. In the CFTC's view, the concepts of "futures contracts" and "options," particularly when applied to transactions involving non-agricultural commodities, were potentially very far-reaching. For example, under the CFTC's Hybrid Instruments Rule, 17 C.F.R. pt. 34, the CFTC has asserted jurisdiction over certain securities and bank deposits whose value is linked to the price of commodities, unless such instruments meet certain criteria for exemption set forth in the Rule. Instruments such as bonds linked to the price of foreign currency and certain types of deposits of foreign currency in U.S. bank accounts may potentially be viewed by the CFTC as commodity futures or options subject to CEA regulation.

Recently, the CFTC has brought a number of enforcement actions asserting jurisdiction over foreign currency derivative transactions that have created significant interpretative issues about the scope of the Treasury Amendment. The CFTC's goal in bringing these enforcement actions -- the protection of unsophisticated investors from the unsavory or fraudulent practices of bucket shops or other unregulated entities -- is an important one, as Treasury has long acknowledged.[1] Unfortunately, the ambiguity created by these enforcement actions has significantly diminished the efficacy of the Treasury Amendment in providing a bright-line exclusion from the CEA for the markets in the enumerated financial instruments. Treasury does not believe that it would be good public policy to solve a discrete enforcement problem in a way that generates legal uncertainty throughout enormously important financial markets.

The CEA's language strongly tends to favor exchange trading, a mode of conducting transactions that developed in connection with agricultural commodities. Various financial futures and options have developed in that environment so successfully that the volume of financial futures and options on the various commodities exchanges, measured in terms of notional value of transactions, far exceeds that of agricultural commodities. However, there is a fundamental question whether that mode of conducting transactions is appropriate for all transactions involving financial instruments that, in the view of the CFTC, may constitute futures contracts or options. The financial markets have provided their own answer to this question: the notional amount of foreign exchange futures contracts traded over-the-counter is several orders of magnitude greater than that traded on exchanges.

The CFTC has some flexibility to address this fundamental question through the general exemptive authority granted to it by Congress in 1992. However, Treasury does not believe that

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[1] Letter from Charles O. Sethness, Assistant Secretary (Domestic Finance), United States Department of the Treasury, to Susan M. Phillips, Chairman, Commodity Futures Trading Commission (May 5, 1986).

reliance on this exemptive authority will provide the needed level of certainty for the foreign currency and government securities markets. One concern is that reliance on the exemptive authority could be interpreted as an implicit conclusion that the exempted transactions in question are futures or options subject to CFTC jurisdiction. Thus, reliance on exemptive authority requires market participants to operate, as a matter of caution, as if the transactions at issue are futures or options and structure their transactions to qualify for the regulatory exemption. If the CFTC later decides to change the parameters of the exemption, market participants would be forced to restructure their transactions accordingly or fall back on the position that the transactions are not, in fact, futures or options subject to the CEA, with all the accompanying legal uncertainty.

Treasury Proposal

In drafting the attached proposal, Treasury was guided by the principle that the appropriate legal standard should provide adequate protection of retail participants while achieving maximum legal certainty for the derivative markets in foreign currency and government securities, as well as the other enumerated financial instruments. Our proposal is structured to provide a broad exemption from the CEA for these transactions without resorting to terms that are undefined, open-ended, or both. Instead, we have attempted to draw the relevant lines by reference to objective factors that can be determined by all interested parties, including market participants. Although we have not expanded the list of covered instruments, we believe consideration must be given to whether the list should be updated and expanded to reflect some of the expansion in the variety of financial instruments since 1974, and the significance of certain products to investors. Recognizing that the resolution of certain issues raised by Treasury's proposal may require us to modify our approach, we would welcome the opportunity to continue to work with the Committee, as necessary, to expand the list of covered instruments, and to resolve other matters raised by our and others' proposals.

1. Exemption for Government Securities Transactions

Treasury's proposal is structured to provide a complete exclusion for transactions in, or in any way involving, government securities unless those transactions are conducted on an organized exchange. Certain other securities transactions currently sheltered by the Treasury Amendment are similarly excluded. Treasury shares the CFTC's concern that the law should not provide a loophole for unregulated entities to defraud retail investors. With respect to these transactions, however, the federal securities laws serve that purpose. Indeed, the government securities market itself is now subject to a regulatory regime that did not exist at the time the Treasury Amendment was adopted. The proposal retains similar treatment for resales of installment loan contracts, mortgages, and mortgage purchase commitments.

The CFTC's proposal, by contrast, would subject entire classes of transactions involving government securities (and other Treasury Amendment instruments) to an additional regulatory scheme that may or may not be consistent with existing law. In particular, the CFTC's draft makes reference to the "when issued" government securities market, in which investors enter into contracts for the purchase of government securities to be issued at a later date. This market is of vital importance to the liquidity of the government securities market and helps to reduce the cost of government borrowing. Treasury believes this market is currently appropriately regulated and that CFTC regulation, or the threat of such regulation, of this market could be detrimental to government finance. Although CFTC staff has stated its belief that the "when issued" market is a "cash" market that is not, and should not be, the subject of CFTC regulation, the draft legislation prepared by the CFTC does not clearly exempt this market from CFTC regulation.

2. Exemption for Foreign Currency Transactions.

A. Transactions between Unregulated Entities and Retail Customers.

Treasury's proposal would permit the CFTC to regulate transactions involving foreign currency that are conducted on an organized exchange It would also confer antifraud authority over foreign currency transactions conducted between any unregulated person and a retail customer. The term "unregulated person" is defined as a person who is not currently regulated by one of the federal bank regulators or is not a broker-dealer or investment company regulated by the Securities and Exchange Commission A "retail customer" is defined in terms of net worth and income, to include any natural person other than a natural person with a net worth above $1,000,000 or with an annual income of more than $200,000 (or $300,000 when combined with one's spouse) This definition is drawn from the SEC's definition in Regulation D, 17 C.F.R. § 230 501, which delineates a class of sophisticated investors for whom the full protections of federal securities regulation are deemed unnecessary.[2] Drawing the line in this fashion clearly permits the CFTC to take regulatory or enforcement actions in the area where needed[3] while preserving the legal certainty originally intended by the Treasury Amendment.

B. Transactions between Regulated Entities and Retail Customers.

Treasury perceives no need for CFTC regulation of transactions involving regulated entities, such as banks and broker-dealers, that may sell foreign currency instruments to small businesses or individuals that do not meet certain net worth or income thresholds. Such customers may have

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[2] By contrast, the CFTC's draft legislation refers to the CEA's existing definition of "appropriate persons " That definition includes, among other persons, banks, insurance companies, investment companies, governmental entities, broker-dealers, and corporations with a net worth exceeding $1,000,000 or total assets exceeding $5,000,000 It is unclear, however, whether the definition would also extend to other persons (such as high-net worth individuals) that are partially exempt from the CEA under current CFTC regulations, but that are not explicitly listed in the statutory definition

[3] The recent CFTC enforcement actions have involved foreign currency transactions between unregulated entities and retail customers

legitimate risk-management needs for specialized instruments that are not available on exchanges, such as futures contracts on particular foreign currencies. The extent of such transactions is extremely limited at present, probably due in part to the uncertain legal environment surrounding such transactions. Granting the CFTC regulatory authority over such transactions could mean that they do not occur, since the CEA is based on the presumption that most non-exchange derivative transactions should be illegal, unless demonstrated otherwise. We believe, however, that regulation of this nature is unwarranted where the entities involved are already subject to extensive schemes of federal regulation Such entities should not be constrained from meeting the needs of their customers.

C. The Institutional Markets

Finally, Treasury believes that it is neither necessary nor appropriate to expand the scope of the CFTC's jurisdiction to regulate any segment of the institutional markets. Thus, we believe that transactions engaged in by persons other than retail customers -- including, but not limited to, banks, broker-dealers, corporations, and individuals whose net worth or income takes them outside of the definition of retail customer -- should not be subject to regulation under the CEA. Institutional participants, whether currently regulated or not, have the sophistication and the financial means to protect themselves and to handle their disputes without the assistance of the CFTC As noted, the limited number of enforcement actions the CFTC has brought over the years have been in the context of bucket shops dealing with unsophisticated retail customers.

Creating a more restrictive or legally uncertain regulatory environment could detrimentally affect the institutional market, causing the foreign currency market to migrate overseas to a more favorable environment Migration of the foreign currency futures and options market could have a spillover effect on that market, resulting in restricted access to these markets for many participants The United States foreign currency market is too large and too important to be subjected to unnecessary regulation or the vagaries of case law created in the context of retail enforcement actions

We note that the CFTC's draft legislation provides that transactions in "defined financial instruments" entered into by "appropriate persons" are entirely exempt from the CEA if the conduct of the persons is "subject to provisions of civil federal law prohibiting fraud and price manipulation other than the [CEA]" It appears that this provision is designed to exempt transactions between banks, broker-dealers, and other regulated entities from the provisions of the CEA, a goal shared by Treasury The law would be greatly clarified, however, if the categories of exempted entities were listed, as they are in Treasury's proposal, rather than leaving the question of coverage open to interpretation by the CFTC and/or the courts. Moreover, the CFTC's proposal does not clearly establish whether all, or only some, of the "appropriate persons" in a given transaction must be subject to other federal laws before the exemption from the CEA would be available Thus, the proposal does not provide a clear exemption for other sophisticated institutional market participants, such as corporations and high-net worth individuals, that are not directly subject to federal regulation

3. <u>Definition of "Organized Exchange"</u>

Under the existing Treasury Amendment, the CFTC retains jurisdiction to regulate certain transactions in Treasury Amendment instruments that occur on a "board of trade." The use of this term, however, has given rise to many of the interpretive difficulties that exist under current law. Treasury's proposal allows continued CFTC jurisdiction over transactions occurring on an "organized exchange" and supplies a detailed definition of this new term. The definition clarifies that entities engaged in the business of buying or selling Treasury Amendment instruments, such as banks, broker-dealers, futures commission merchants, and government securities dealers and brokers, will not be deemed to be organized exchanges; rather, the definition includes entities that serve as a marketplace for arms' length transactions.

Treasury Amendment Legislation

SEC. 101. TREASURY AMENDMENT CLARIFICATION.

Section 2(a)(1)(A) of the Commodity Exchange Act (7 U.S.C. 2(ii)) is amended--

(a) by striking clause (ii) and inserting the following:

"(ii) Except as provided for in subsection (iii), this chapter shall not apply to and the Commission shall have no jurisdiction over transactions in or in any way involving foreign currency, unless the transaction is a contract of sale for future delivery or an option and is conducted on an organized exchange."

(b) by adding at the end the following new subsections:

"(iii) Sections 4b and 4o of the Commodity Exchange Act (7 U.S.C. 6b & 6o) and any antifraud regulation promulgated by the Commission pursuant to 4c(b) of the Act (7 U.S.C. 6c(b)) shall be applicable to transactions in or in any way involving foreign currency if the transaction is a contract of sale for future delivery or an option and is conducted between any unregulated person and a retail customer."

"(iv) This chapter shall not apply to and the Commission shall have no jurisdiction over transactions in or in any way involving security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless the transaction--

(I) is a contract of sale for future delivery, or an option on either a future or a commodity that is not a security, and

(II) is conducted on an organized exchange.

"(v) The following definitions shall apply for purposes of this section

(I) REGULATED PERSON

(a) The term "regulated person" means a person that is regulated or supervised by an appropriate federal banking agency as the term is defined in section 903 of International Lending Supervision Act (12 U.S.C. 3902), a government securities broker, a government securities dealer, or a registered broker or dealer as defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C

78c(a)); or an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8); or

(b) an affiliate of a person described in subclause (a), but only to the extent that the affiliate conducts a transaction (other than a transaction conducted on an organized exchange) covered by section 2(a)(1)(A)(ii) or section 2(a)(1)(A)(iv) through such a person.

(II) UNREGULATED PERSON

The term "unregulated person" means any person other than a regulated person.

(III) RETAIL CUSTOMER

The term "retail customer" means any natural person other than--

(a) a natural person whose net worth, or, in the case of a natural person who is married, joint net worth with that person's spouse, exceeds $1,000,000, or

(b) a natural person who had an income in excess of $200,000 in each of the two most recent years, or in the case of a natural person who is married, joint income with that person's spouse in excess of $300,000 in each of those years

Provided, that the term "retail customer" shall not include any person to the extent that such person is represented by a regulated person in a transaction (other than a transaction conducted on an organized exchange) described in section 2(a)(1)(A)(ii) or section 2(a)(1)(A)(iv).

(IV) ORGANIZED EXCHANGE

(a) Except as otherwise provided in this subclause, the term "organized exchange" means--

(1) a board of trade designated by the Commission as a contract market or a physical or electronic market place or similar facility affiliated with a board of trade so designated as a contract market, or

(2) a physical or electronic market place or similar facility through which unaffiliated persons, for their own accounts or for the accounts of customers, enter into and execute arms' length binding transactions by accepting bids and offers made by one person that are open to all persons who conduct business through such market place or similar facility.

(b) Notwithstanding subclause (III)(a), the term "organized exchange" does not include--

(1) parties engaged in privately negotiated bilateral transactions, even if such parties use electronic means to communicate or execute transactions, or

(2) government securities dealers or brokers, as defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)).

(V) OPTION

The term "option" means a transaction described in Section 4c(b) of this Act "

SEC 102 SAVINGS CLAUSE

Nothing in section 101 of this Act shall be interpreted as altering the Futures Trading Act of 1982 (Pub L No 97-444)

Explanation

In general, the amendment would exempt transactions in or in any way involving foreign currency from the Commodity Exchange Act (CEA), that would otherwise be subject to the CEA, unless the transactions were conducted on an organized exchange. The amendment would permit over-the-counter foreign exchange transactions between unregulated persons and retail customers, but such transactions would be subject to CFTC anti-fraud authority under sections 4b and 4o of the CEA The amendment adds the term "in any way involving" to clarify that options and cash settled transactions are within the scope of the Treasury Amendment exemption, as are transactions involving the values, yields, or rates on the listed instruments.

Additionally, transactions in or, in any way, involving security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments are exempted from the CEA unless the transaction is a future or an option on a future or a commodity that is not a security and is conducted on an organized exchange.

The amendment would add new definitions of "regulated person", "unregulated person", "retail customer", "organized exchange" and "option" to the CEA. A "regulated person" is a person who is currently regulated by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation. The definition is intended to include banks, savings associations, foreign banks, holding companies, operating subsidiaries, affiliates, service corporations, Edge Act corporations, and Agreement Corporations operating under section 25 of the Federal Reserve Act. Additionally, the term includes particular entities registered with the Securities and Exchange Commission such as government securities brokers and dealers. Finally, the term includes affiliates of such persons, but only to the extent that the affiliate conducts a covered transaction through such persons The term "unregulated person" means any person other than a regulated person.

The term "retail customer" has been defined to mean any natural person other than (a) a natural person whose net worth exceeds $1,000,000, or (b) a natural person whose annual income exceeded $200,000 (or whose joint income with that person's spouse exceeded $300,000) in each of the last two years The term does not include, however, a person who is represented by a regulated person

The term "organized exchange" has been defined to mean both (1) a board of trade designated by the CFTC as a contract market and affiliated exchange-like facilities, and (2) a physical or electronic market place or similar facility by means of which unaffiliated persons engage in arms' length binding transactions by accepting bids or offers made by one person that are open to all persons who conduct business on the facility The definition is intended to clarify that entities that are engaged in the business of buying or selling Treasury Amendment instruments, such as banks, broker-dealers, futures commission merchants, and government securities dealers and brokers, are not "organized exchanges"

The term "option" is defined to include any transaction involving any commodity regulated under the CEA which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty".

The amendment includes a savings clause to clarify that the amendment may not be interpreted as altering the Futures Trading Act of 1982, Pub. L. No. 97-444, the so-called "Shad-Johnson Accord" Among other things, this Act imposed restrictions on the CFTC jurisdiction over options on securities and options on foreign currency traded on a national securities exchange, which are now regulated by the Securities and Exchange Commission.

Introduction

The Commodity Exchange Act (the "CEA") vests the Commodity Futures Trading Commission (the "CFTC") with "exclusive jurisdiction" over commodity futures and options, and outlaws all commodity futures and options transactions that are not conducted in accordance with the CEA and the regulations promulgated by the CFTC. As a result, certainty about the legal status of transactions that may fall within the scope of the CEA -- such as over-the-counter ("OTC") derivatives -- is extremely important since a transaction that is premised on an understanding of the law that is subsequently rejected by the courts could be unenforceable. Legal uncertainty of this nature presents systemic risk issues, because parties to classes of transactions that were found to be unenforceable could repudiate their obligations. Legal uncertainty may also inhibit the development of risk-reducing systems, such as clearinghouses, because the regulatory regime to which such systems may be subject is uncertain.

The proposals discussed below are aimed at reducing legal uncertainty in the OTC derivatives markets. They reflect a judgment that the CEA is, in most cases, unsuited to the regulation of these markets~~, since the CEA is principally focused on the regulation of exchanges and exchange-traded instruments~~. However, proposals to enhance legal certainty by excluding certain derivative transactions or market participants from the CEA are not at odds with proposals to enhance oversight by other agencies of the derivatives activities of banks, broker/dealers, and their affiliates. Rather, the overall goal of these proposals is to insure that regulation is clear in scope and appropriate to the characteristics of the markets.

I. Swap Exemption and Hybrid Instrument Rule

Current Law. In 1989, the CFTC issued a Policy Statement Concerning Swap Transactions (the "Policy Statement"), which reflected the agency's view at that time that "most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the [CEA] and regulations." At that time, the CFTC lacked the authority to exempt ~~transactions~~futures contracts from the exchange-trading requirement of the CEA, so market participants understood the Policy Statement as a determination by the CFTC that "most" swaps are not within the scope of the CEA (i.e., they are not commodity futures or options).[1]

In 1992, Congress amended the CEA to give the CFTC authority to exempt transactions from all provisions of the CEA except a provision that codified an agreement between the CFTC and the Securities and Exchange Commission (the "SEC") about the respective jurisdiction of those

[1] The CFTC did have exemptive authority for commodity options at that time, but the Policy Statement did not purport to exercise this authority with respect to options.

agencies (known as the "Shad-Johnson Accord").[2] Congress also indicated that the CFTC should use its authority to exempt swaps from the CEA "to the extent that such agreements may be regarded as subject to the provisions of [the CEA]." 7 U.S.C. § 6. In other words, Congress indicated that swaps should not be regulated under the CEA, but did not clearly establish that swaps are commodity futures or options that would be subject to the CEA in the absence of an exemption.[3]

In 1993, the CFTC adopted the Swap Exemption, which exempts certain swap agreements from all provisions of the CEA except the Shad-Johnson Accord and the CEA's anti-fraud provisions. 17 C.F.R. pt. 35.[4] The limitations on the scope of the Swap Exemption are implicitly at odds with the apparent rationale for the Policy Statement, since swaps could not be subject to the CEA's anti-fraud provisions unless they actually are commodity futures or options.

A swap agreement must meet the following criteria to fall within the scope of the Swap Exemption:

(1) The swap agreement must be entered into between eligible swap participants. "Eligible swap participants" are defined to include various regulated financial institutions, business enterprises that meet certain tests relating to total assets or net worth, certain pension funds, state and local governments, and individuals with more than $10 million in total assets.

(2) The swap agreement may not be part of a fungible class of agreements that are standardized as to their material economic terms.

(3) The creditworthiness of the parties to the swap agreement must be a material consideration in entering into and determining the terms of the swap agreement.

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2 The consequences of the Shad-Johnson Accord are discussed further in Section II below.

3 Congress also enacted a similar provision authorizing the exemption of "classes of hybrid instruments that are predominantly securities or depository instruments." Id.

4 The CFTC also adopted its Hybrid Instrument Rule, which exempts securities and bank deposits that have some of the characteristics of commodity futures or options from all of the provisions of the CEA except the Shad-Johnson Accord. 17 C.F.R. pt. 34. To qualify for the exemption, a hybrid instrument must derive more than 50% of its value (as determined by a calculation methodology specified in the exemption) from aspects of the instrument that are not related to the value of commodities, must be subject to securities or banking laws and sold to persons eligible to purchase the instrument under such laws, and must satisfy certain criteria regarding marketing, payment terms, and settlement.

(4) The swap agreement may not be entered into and traded on or through a multilateral transaction execution facility.

Reason for Change. The Swap Exemption has been only partially successful in alleviating legal uncertainty in the swaps market. Earlier this year, the CFTC published a "Concept Release" that requested comment on whether the Swap Exemption should be amended to provide that market participants must comply with more rigorous requirements to be eligible for the exemption. Because it has never been conclusively determined that swap agreements are in fact commodity futures or options, it is not clear that the CFTC can impose any restrictions on the market (including those found in the current Swap Exemption). ~~If the CFTC imposes onerous restrictions without clear~~

In effect, the Concept Release attempts to turn the purpose of the law that authorized exemption of the swaps market on its head, by suggesting that the CFTC can use its exemptive authority to craft a regulatory scheme. In the absence of further Congressional ~~authorization~~action, ~~market participants are likely to challenge~~this effort lacks legitimacy, and the agency's authority would likely be challenged by market participants in court. Such litigation could result in an incoherent regulatory framework, in which certain types of swaps are held to be futures or options that must comply with CFTC regulations in order to be enforceable, while other types of swaps are held to be entirely excluded from the CFTC's jurisdiction. Many have expressed the view that the markets in question are too large and important to be subject to this sort of legal uncertainty~~, and that any regulatory framework for the markets should be crafted by Congress, rather than by a regulatory agency exercising exemptive authority~~.[5]

In addition, the Swap Exemption itself has several ambiguities that should be resolved. First, swap agreements have become increasingly standardized over time, as a natural result of the maturing of these markets. There is concern that the CFTC or a court may determine that certain types of swaps do not meet the requirement that ~~exempt~~ swaps must not be part of a fungible class of agreements that are standardized as to their material economic terms. If the swaps are also found to be commodity futures or options, it follows that they are illegal and unenforceable (unless some other exemption from the CEA, such as the trade option exemption, is available).

Second, the term "multilateral transaction execution facility" is not defined in the Swap Exemption. However, the CFTC has explained that the term refers to a physical or electronic

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[5] The Concept Release also sought comment on whether the Hybrid Instrument Rule should be amended, thereby raising similar questions as to the CFTC's authority ~~to impose restrictions on instruments that are not clearly commodity futures or options.~~. The Hybrid Instrument Rule is premised on the view that instruments qualifying for the exemption are subject to regulation by the SEC or bank regulatory agencies. Because the CEA gives the CFTC "exclusive jurisdiction" over futures and options, an assertion by the CFTC of regulatory authority over hybrid instruments would raise questions about the authority of other agencies to regulate these instruments.

facility that links market participants simultaneously with the capability of entering into binding contracts among themselves. As a result, there is a concern that the CFTC or a court may determine that the use of screen-based trading systems that match swap counterparties, or clearinghouses that net counterparties obligations, ~~are~~would make swaps subject to the CEA because they increase the similarity between swaps and comparable exchange-traded futures or options.

~~Third, in promulgating the Swap Exemption, the CFTC stated that swaps cleared through a clearinghouse that served as a central counterparty would not qualify for the exemption, since the clearinghouse would serve to mitigate credit risk, and would make cleared swaps more like exchange-traded instruments. As a result, the current Swap Exemption inhibits the development of systems that may serve to reduce systemic risk.~~

Proposal. Treasury staff proposes that Congress amend the CEA to exclude qualified swap agreements from the CEA.[6] An exclusion from the CEA is preferable to the current exemption, because it would eliminate uncertainty about the effect of CFTC regulatory action on these markets. The proposed exclusion would conclusively establish that swaps that qualify for the exclusion ~~do not fall within the scope of a statute that is unsuited to the regulation of OTC markets~~are not covered by the CEA.[7]

The exclusion would retain some of the requirements of the current Swap Exemption. Transactions would qualify only if conducted between appropriate persons. The requirement that creditworthiness of counterparties be a material consideration would also be retained, to insure that swaps qualifying for the exclusion are not fungible instruments that compete directly with exchange-traded instruments.[8] ~~**[Some policy input is needed here. Retaining the creditworthiness requirement would be at odds with encouraging clearinghouses that serve as central counterparty. Yet I presume we wish to encourage the development of such clearinghouses.]**~~ However, the limitation on standardized terms would be eliminated, since it creates uncertainty as to the scope of the exclusion while adding little to the limitation on fungibility that is implicit in the requirement for consideration of credit risk.

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[6] This proposal is consistent with the position taken by Treasury in debate about the CEA last year.

[7] Treasury staff also proposes codifying the Hybrid Instrument Rule as an exclusion of covered instruments from the CEA. Although the Hybrid Instrument Rule does not raise as many legal certainty issues as the Swap Exemption, an exclusion would resolve questions about the CFTC's authority to qualify an exemption by imposing greater restrictions, and would clarify that other laws (such as securities or banking laws) may apply to such instruments.

[8] We note that keeping the creditworthiness requirement would impose limits on how any potential swaps clearinghouses are structured.

Finally, the limitations on transactions conducted through multilateral transaction execution facilities would be replaced by a requirement that transactions not occur through an "organized futures exchange." An organized futures exchange would be defined in the statute to include recognized futures and options exchanges, securities exchanges and securities associations, and anything functionally equivalent to a recognized exchange. The definition of functional equivalency would focus on the main attributes of current futures and securities exchanges, including the potential for participation by the general public, the ability to make trades for the account of customers, and the availability of all bids and offers to all persons doing business through the facility. The definition would exclude clearinghouses and electronic screen-based trading systems. ~~[Any ambiguity remaining in the definition could be addressed by giving [the CFTC] [Treasury] [the Federal Reserve] explicit authority to issue rules interpreting the definition.~~[9]

II. Swaps and Futures on Non-Exempt Securities

Current Law and Reason for Change. The Shad-Johnson Accord prohibits futures on securities other than (1) securities that are exempt from the securities laws or (2) broadly-based security indices. Moreover, the CFTC cannot provide exemptions from this restriction, since the agency's exemptive authority does not extend to the provisions of the Shad-Johnson Accord. Thus, to the extent that a swap involving a security that is not exempt from the securities laws (a "non-exempt security"), such as an equity swap, a credit swap, or an emerging market swap, is deemed to be a commodity futures contract, it would be illegal, and the Swap Exemption would not (and could not) protect it.

Swap markets in these instruments have developed, however, due to the CFTC's statements in the Policy Statement that "most" swaps are not appropriately regulated as commodity futures or options. The CFTC's Concept Release greatly unsettled these markets, because statements implying that swaps might be viewed as futures were tantamount to saying that swaps in non-exempt securities might be illegal. Legislation enacted as part of this year's Omnibus Appropriations Act temporarily alleviated this problem to some extent by freezing until March 30, 1999, the pre-existing legal status of swaps entered into in reliance on the Policy Statement (but without actually clarifying what that legal status is).

Proposal. Treasury staff proposes including swaps on non-exempt securities within the scope of the exclusion from the CEA discussed above.[10] This change in the law would clarify that these swaps are entitled to the same legal status as other swaps if they fall within the terms of the exclusion. Because swaps on non-exempt securities can be used as substitutes for direct

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[9] The regulation of screen-based trading systems and clearinghouses is discussed in Sections IV and V below.

[10] Again, this is consistent with positions taken by Treasury in the past.

investments in securities, however, they would be subject to the anti-fraud jurisdiction of the SEC (and possibly other provisions of the securities laws). Thus, these markets would benefit from greater legal certainty, but would be subject to regulation.

Treasury staff also proposes repealing the provision of the Shad-Johnson Accord that bans exchange-traded futures on non-exempt securities, and giving the SEC authority to regulate such instruments, in order to address the "level playing field" concerns of futures exchanges.

III. Treasury Amendment: Foreign Currency and Government Securities Derivatives

Current Law. The Treasury Amendment excludes certain derivatives transactions in foreign currency, government securities, and certain other non-physical commodities from the CEA. Although some uncertainty about the scope of the Treasury Amendment was resolved by last year's Supreme Court decision in CFTC v. Dunn, legal uncertainty continues to revolve around the Treasury Amendment's use of the term "board of trade."

"Board of trade" is defined in the CEA to mean "any exchange or association, whether incorporated or unincorporated, of persons who are engaged in the business of buying or selling any commodity or receiving the same for sale on consignment." 7 U.S.C. § 1a. The term has two important functions in the CEA: First, it is used in the provisions of the CEA and CFTC regulations that require any commodity futures or options transaction to be conducted on a "board of trade which has been designated by the Commission as a 'contract market'." Thus, futures and options trading in a particular commodity may occur only on a board of trade that has effectively been licensed by the CFTC for that purpose. Second, the term "board of trade" is used to limit the scope of the Treasury Amendment: transactions involving Treasury Amendment products (such as foreign currency and government securities) are excluded from the CEA unless conducted on a board of trade.

Reason for Change. The Treasury Amendment is a statutory exclusion that provides one of the legal legs on which the OTC market rests. The "board of trade" clause of the Treasury Amendment limits the exclusion. A clear understanding of "board of trade" in the Treasury Amendment is therefore critical for determining which transactions are not subject to CFTC jurisdiction. As defined in the CEA, the term "board of trade" is potentially quite broad. This breadth arguably makes sense for certain provisions of the CEA, such as the provisions that effectively bring all futures and options trading under CFTC jurisdiction. However, as some courts have recognized, this breadth makes no sense at all in the context of the Treasury Amendment. In such a context, in order for the exclusion to have any meaning, any exceptions to it must be narrow and clear.

In light of recent actions, the CFTC appears to have a broad view of the meaning of "board of trade." Courts that have interpreted the term "board of trade" in the context of the Treasury

Amendment have generally agreed that Congress could not have intended a literal application of the CEA's definition of that term for the purposes of the Treasury Amendment, since such a reading severely limits, if not obliterates, the scope of the Treasury Amendment. However, the courts are divided over just what the term does mean in that context. One court (the Ninth Circuit) has said that "board of trade" in the Treasury Amendment means "organized futures exchange," while another (a district court in the Second Circuit) has said that term means anything other than the interbank market. Such legal ambiguity chills market ~~activity~~innovation and invites further litigation. For example, "board of trade" concerns have been expressed about entities trying to develop communication systems to facilitate trading of foreign currency forwards, and a government securities clearinghouse that is seeking to clear repurchase agreement transactions.[11]

Proposal. ~~The~~Last year, Treasury formally proposed that the term "board of trade" in the Treasury Amendment ~~would~~ be replaced by the term, "organized futures exchange~~,"~~." See Letter from Secretary Rubin to Chairman Lugar (Feb. 3, 1997) (Tab A). The term would be defined in the manner discussed above in connection with swaps, in order to harmonize the Treasury Amendment exclusion with the swaps exclusion ~~for swaps discussed above~~.

IV. Trading Systems

Current Law and Reason for Change. Broker-dealers that sponsor or operate automated systems for receiving or displaying and matching or crossing orders for securities transactions (called "broker-dealer trading systems") are required to register such systems with the SEC, to keep records of participants, transactions and orders, and to file reports with the SEC. ~~Earlier this year, t~~The SEC ~~proposed~~is expected to approve rules on December 2 expanding its regulation of some of these systems. Trading systems for government securities brokers and dealers are not subject to ~~this requirement~~these regulations, but are subject to oversight by Treasury or the federal bank regulatory agencies.

The development of similar trading systems for OTC derivatives has been inhibited by uncertainty about the applicability of the CEA, since a trading system may be deemed to be a "multilateral transaction execution facility" or a "board of trade." Systems that have been developed -- such as government securities derivatives systems operated by inter-dealer government securities brokers, or systems for foreign exchange trading that are based in London but are available to U.S.

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11 The debate about the meaning of "board of trade" may be influenced by soon-to-be published SEC rules that will exempt, but not exclude, government securities automated trading systems from a revised regulatory definition of "exchange." If such systems are "exchanges" (albeit exempted ones) for purposes of the securities laws, the CFTC may argue that they are also "boards of trade" when they trade derivatives.

customers – must evaluate legal risks in making decisions about what products they will trade or how they structure their business.

This issue is further complicated by the views of the traditional futures exchanges, which would ~~view~~consider the development of extensive trading systems for OTC derivatives ~~as~~to be a competitive threat. For several years, these exchanges have lobbied for a relaxation of the CEA that would allow them to develop "professional markets" (also known as "pro markets") – lightly regulated futures exchanges that are open only to sophisticated investors – in order to compete more effectively with OTC markets.

Proposal.

As discussed above, Treasury staff recommends that the terms "multilateral transaction execution facility" in the Swap Exemption and "board of trade" in the Treasury Amendment be replaced by a new defined term, "organized futures exchange." In the drafting of this definition, particular attention would be given to clarifying the status of trading systems.[12]

Trading systems for OTC derivatives would not be organized futures exchanges if they met certain "safe harbor" criteria, such as limiting their trading to non-physical commodities (i.e., commodities other than agricultural or mineral products) and limiting system access to sophisticated parties trading as principals. As a result, trading systems meeting these standards would not be subject to direct regulation, since the participants in the markets would not need government assistance to protect their interests. As described below, however, clearinghouses associated with trading facilities would be regulated to address systemic risk concerns. In order to provide "pro market" relief to futures exchanges, the proposal would clarify that futures exchanges could establish affiliates that would qualify for the safe harbor. This is significantly less "relief" than the exchanges have sought, but we believe that it should be appealing to them as an approach to "leveling the playing field."

The proposal would not make any changes to current law with respect to securities trading systems. The proposal would clarify, however, that trading systems for government securities derivatives would be treated like systems for other OTC derivatives on non-physical commodities.

V. Clearinghouses

Current Law.

Futures. Although the CEA does not explicitly give the CFTC authority over commodity futures or option clearinghouses, it is generally settled that the CFTC has the authority to regulate

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[12] This proposal is similar to positions that Treasury has taken in the past.

clearing when it is performed by or for a CFTC-designated contract market, even when the clearing is performed by a separately incorporated clearing corporation. CFTC regulations place various requirements on clearing organizations, including requirements for recordkeeping, segregation and investment of customer funds, and submission of rules for CFTC approval. The CFTC also has worked closely with the SEC on cross-margining of futures and securities positions on CFTC- and SEC-regulated exchanges.

~~However, t~~The CFTC's authority over the clearing of instruments that are *not* traded on a CFTC-designated contract market is questionable, however, despite the agency's assertions of jurisdiction. In its May 1998 Concept Release, the CFTC stated its belief that the clearing of swaps is not permitted under the Swap Exemption. Presumably the agency would have similar views on clearing facilities for all other instruments that are exempted from the CEA, such as foreign currency. In an October 8, 1998, comment letter on the CFTC's Concept Release, the Foreign Exchange Committee, a group of major domestic and foreign commercial and investment banks and foreign exchange brokers, argued that the CFTC does not have statutory authority to regulate clearing entities that are not connected to a CFTC-regulated exchange or contract market, and that the agency's position created legal uncertainty that caused some of their members to consider moving their business offshore.

In response to CFTC actions, on June 15, 1998, the London Clearing House (LCH) filed a petition for exemptive relief with the CFTC that would permit qualified U.S. entities to use a clearing facility being developed by LCH for interest rate swaps and forward rate agreements. In addition, CLS Services, a U.K. holding company that is developing a foreign exchange clearing facility called the Exchange Clearing House Limited (ECHO), has approached Treasury for a clarification of the application of the CEA to ECHO.

Securities. Unlike the CFTC, the SEC has explicit authority to register and regulate clearing agencies for the clearance and settlement of securities (other than exempt securities) *and* to facilitate the establishment of linked or coordinated facilities for the clearance and settlement of transactions in securities, securities options, futures, options on futures, and commodity options. In exercising this authority, the SEC is required to coordinate with the CFTC and consult with the Federal Reserve.

Reasons for Change. The legal uncertainty surrounding the CFTC's authority for the clearing and settlement of financial instruments that are *not* traded on a CFTC-designated contract market has slowed the development of clearing entities for OTC instruments such as swaps and foreign exchange contracts. This uncertainty has unnecessarily retarded the development of systems that can reduce settlement risk and ultimately systemic risk and contribute to the efficient operation of financial markets.

Proposal. Treasury staff recommends seeking legislation that would provide the CFTC with explicit statutory authority to regulate the clearing and settlement *only* of instruments that are traded on CFTC-designated contract markets. Such a proposal also should provide the CFTC with a statutory directive (modeled after the SEC's requirement) to coordinate with the SEC and the Federal Reserve to facilitate the establishment of linked or coordinated facilities for ~~the~~ clearance and settlement.

Treasury staff recommends leaving unchanged the SEC's authority to oversee securities clearinghouses.

Finally, for clearinghouses that may develop for interest rate, currency and other swaps, foreign exchange, and other financial instruments not explicitly overseen by the SEC or CFTC, we recommend pursuing legislation that would give jurisdiction to the Federal Reserve, as a regulator of such clearinghouses if they do not also clear securities or futures contracts. This should remove the legal uncertainty surrounding the development of swaps and foreign exchange clearing organizations and provide an avenue for reducing systemic risk. Moreover, the allocation of regulatory authority among the CFTC, the SEC and the Federal Reserve would be consistent with the respective jurisdiction of those agencies over products and market participants.

VI. Limits on CFTC Anti-Fraud Authority

Current Law. The CFTC has broad anti-fraud authority that is designed to provide the agency with considerable leeway in addressing unauthorized practices by entities regulated by the CFTC (such as futures commission merchants, introducing brokers, and commodity trading advisors) and those who are not regulated by the agency but who offer or sell products that are subject to the CFTC's jurisdiction. The CFTC currently does not have anti-fraud jurisdiction over transactions covered by the Treasury Amendment, however, unless such transactions are commodity futures or options and are conducted on a "board of trade." As discussed above, the meaning of the term "board of trade" is the subject of considerable uncertainty. Moreover, although the CFTC has asserted that it has anti-fraud authority over swaps, this assertion of authority is legally supportable only if the products in questions actually are commodity futures or options. Since the legal status of these instruments is not clear, the scope of the CFTC's anti-fraud jurisdiction is not clear either.

Reasons for Change. Despite questions about the scope of its authority, the CFTC has actively pursued enforcement actions against foreign exchange "bucket shops" (i.e., unregulated entities that deal with the general public) in which the CFTC contends that the entities are "boards of trade" that are trading illegal futures or options contracts. These enforcement actions have resulted (and will continue to result) in litigation about the meaning of the term "board of trade" that has spillover effects on OTC markets for foreign currency and government securities. The situation creates an undesirable "Catch-22," in which decisions that uphold the authority of the CFTC to pursue fraud may undermine the enforceability of legitimate derivatives transactions in foreign currency and government securities.

The CFTC has not, to date, initiated enforcement actions in the swap market that have tested the agency's assertion of jurisdiction. If such enforcement actions are initiated in the future, however, they are likely to result in litigation that may ultimately be damaging to the markets in question.

Proposal. Last year, Treasury proposed legislation that would give the CFTC specific authority to prosecute fraud by unregulated entities that sell foreign exchange products to retail customers (i.e., "bucket shops"). See Tab A. This proposal would allow the CFTC to pursue these actions without having to litigate questions concerning the agency's authority. However, the legislation would exclude transactions in other Treasury amendment products (including government securities) from CFTC jurisdiction unless they are conducted on an organized futures exchange, since ~~most~~there has been no showing of a need for greater regulation. Many of the products in question are ~~either~~ securities (and therefore subject to SEC jurisdiction) ~~[or products that are not susceptible to abuse in retail markets (such as mortgages).] **[Can anyone think of a more compelling rationale?]** –~~, and most market participants are either regulated by the SEC or the banking agencies or are sophisticated institutions that are capable of seeking redress for wrongs done to them.

As discussed above, Treasury staff also recommends excluding swaps and hybrid instruments from the CEA. As a result, transactions covered by the exclusion would not be subject to CFTC anti-fraud jurisdiction. In the case of swaps, this result is appropriate because market participants must be "appropriate persons" in order to participate in the market. Persons covered by the definition of "appropriate persons" – such as banks, broker/dealers, large corporations, and high-net worth individuals – do not need government regulation to protect themselves from fraud, and can avail themselves of common law remedies if they have been defrauded. In the case of hybrid instruments, products excluded from the CEA are subject to oversight by the SEC or federal bank regulators.

VII. Exclusive Jurisdiction of the CFTC

Current Law and Reason for Change. The CEA gives the CFTC "exclusive jurisdiction" over commodity futures and options, which means that a transaction that is regulated by the CFTC cannot be regulated by any other federal or state agency. This provision of the CEA has made "turf" disputes between the CFTC and other regulators particularly difficult, since a successful assertion of jurisdiction by the CFTC over a market would divest other regulators of authority over that market. Thus, an assertion of jurisdiction over hybrid instruments would be seen as a challenge to the authority of the SEC and the bank regulatory agencies to instruments that are securities or bank deposits. Similarly, the SEC's recently adopted rules for specialized regulation of OTC derivatives dealers associated with broker/dealers (known as "broker/dealer lite") was challenged by the CFTC as an assault on that agency's supposed exclusive jurisdiction over derivatives.

Proposal. Treasury staff recommends replacing the exclusive jurisdiction clause with a provision that would allow the CEA to preempt state law, but not the authority of other federal regulators.

TREASURY CLEARANCE SHEET

NO. ____________

Date December 2, 1998

MEMORANDUM FOR: X SECRETARY X DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING X INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER

FROM: Edward S. Knight, General Counsel
Roger L. Anderson, Deputy Assistant Secretary (Federal Finance) RLA 12/3/98
THROUGH: John D. Hawke, Jr., Under Secretary (Domestic Finance)
Gary Gensler, Assistant Secretary (Financial Markets)
TO: Secretary Rubin, Deputy Secretary Summers
SUBJECT: Legal Certainty Issues Associated with Over-the-Counter Derivatives

REVIEW OFFICES

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Roberta McInerney	[illegible]	12/2/98	GB/2026	x2-1988

NOTE:

☐ Review Officer ____________ Date: ____________ ☐ Executive Secretary ____________ Date ____________

1999-SE-011311

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.
October 15, 1999

ASSISTANT SECRETARY

MEMORANDUM FOR SECRETARY SUMMERS
DEPUTY SECRETARY EIZENSTAT

THROUGH: Gary Gensler
Under Secretary
(Domestic Finance)

FROM: Lee Sachs
Assistant Secretary
(Financial Markets)

SUBJECT: Report of the President's Working Group on Financial Markets on OTC Derivatives Markets and the Commodity Exchange Act

A principals' meeting of the President's Working Group on Financial Markets ("PWG") has been scheduled for Tuesday, October 19. The purpose of this meeting is to discuss and obtain final approval of the report on OTC derivatives and the Commodity Exchange Act ("CEA"). A few controversial issues remain regarding the report, at least one of which may require resolution at the principals' meeting. We are in ongoing discussions with the other agencies to try to reach consensus on the open issues.

Attached for your information is the most recent version of the report. This version is now in the interagency clearance process, and we hope to have clearance on Monday, October 18. We plan to make the report public on Monday, October 25. Senator Lugar, chairman of the Senate Agriculture Committee, tentatively plans to hold a hearing on the report on October 27. However, given the ongoing state of discussions regarding the remaining issues, it is possible that this timetable will have to be revised.

This memorandum provides a brief summary of the report, focusing on the recommendations, and explores in greater detail the issues that are likely to arise in Tuesday's discussion.

<u>**Overview**</u>

Overall, the Working Group concluded that the current legal and regulatory structure requires updating in order to encourage innovation and competition, reduce systemic risk, and maintain US leadership in the market for derivatives. More specifically, the Working Group report focuses on changes to the Commodity Exchange Act ("CEA") that are necessary to enhance the extent to which OTC derivatives transactions may be conducted with legal certainty. The Working Group's recommendations include:

Changes in the Treasury amendment providing for (i) continued CFTC jurisdiction over products sold on an "organized exchange" (currently, the statute references the more ambiguous term "board of trade"); (ii) explicit CFTC jurisdiction over "bucket shop" operations that cater to retail customers; and (iii) a clarification that all other foreign currency transactions are excluded from CFTC jurisdiction.

Removing legal uncertainty by creating a statutory exclusion for bilateral swap agreements from the Commodity Exchange Act (CEA), provided certain conditions are met.

Amending the CEA to clarify that entering into or trading swaps through electronic trading systems does not provide a basis for regulation of the system, provided certain conditions are met.

Permitting the use of clearing systems for OTC derivatives, though such clearing systems would be subject to regulation. A "clearing system" would be defined as a system in which the obligations of counterparties to a transaction are discharged and replaced by obligations of a central counterparty or by other participants in the system.

Modification of the CFTC's "exclusive jurisdiction" clause so that the CEA is not construed as limiting the authority of the SEC and the bank regulatory agencies with respect to "hybrid instruments." (In addition, the PWG will continue to consider the merits of a broader modification of the exclusive jurisdiction clause.)

Summary of Report

The report begins by providing a background on over-the-counter derivative instruments and the issue of legal certainty. In particular, the report notes the growth of the OTC market in recent years, and the problems that have been posed by the lack of legal certainty. Legal certainty issues have already begun to inhibit financial institutions from developing and offering new instruments and new initiatives to manage risk and have the potential to damage the competitiveness of US financial markets.

After providing such background, the report explores issues regarding swap agreements, focusing on the need for legal certainty in a variety of arenas, including electronic trading systems. The Working Group recommends increasing legal certainty by excluding from the CEA swap agreements that meet certain criteria - specifically, they must be bilateral agreements by eligible parties on a principal-to-principal basis. The exclusion would explicitly cover swaps that reference securities; legal uncertainty for some of these swaps was increased last year by the CFTC's "Concept Release" on over-the-counter derivatives. The Working Group believes this change is warranted because the participants in such transactions are generally capable of making informed investment decisions and do not require additional protections. In addition, the activities of most derivatives dealers are already subject to direct or indirect federal oversight.

The report then addresses legal certainty for swaps in the area of electronic trading systems, noting that excessive regulation could hinder technological innovation in the OTC derivatives market. The Working Group recommends that the CEA be amended to clarify that excluded swap agreements entered into through electronic trading systems that meet certain qualifications maintain their exclusion, and do not provide a basis for regulation of the system. Qualifications include that such a system must be one in which eligible participants act solely for their own account. Our relatively deregulatory approach to electronic trading systems is based on the Working Group's desire to encourage innovation, efficiency and competitiveness in electronic trading systems involving sophisticated parties. We do, however, note that some regulation may become necessary as electronic trading systems develop and grow. For example, limited regulation aimed at enhancing market transparency and price discovery might become necessary if problems of the sort that are appropriately addressed by regulation emerge, but that further regulation does not appear to be warranted at this time. Our recommendations involving electronic trading systems are the area of greatest debate among the Working Group members. (See "Potential Areas of Controversy", below.)

The final recommendation regarding swaps relates to clearing systems. Clearing systems have the potential of reducing systemic risk. The Working Group recommends that Congress enact legislation to provide a clear basis for the regulation of clearing systems that may develop for OTC derivatives, and provides details regarding recommended features of such a comprehensive regulatory framework. Legislative action would have the beneficial effects of encouraging the development of such systems by clarifying their legal status, subjecting them to appropriate supervision, and ensuring that US firms, initiatives and markets are not at a competitive disadvantage.

The report next explores suggested modifications to the Treasury Amendment. Certain specific language within the Amendment has contributed to the legal uncertainty surrounding OTC derivatives. The Working Group recommends changes in the Treasury amendment providing for (i) continued CFTC jurisdiction over products sold on an "organized exchange" (currently, the statute references the more ambiguous term "board of trade"); (ii) explicit CFTC jurisdiction over "bucket shop" operations that cater to retail customers; and (iii) a clarification that all other foreign currency transactions are excluded from CFTC jurisdiction.

Hybrid instruments are the next topic addressed by the Working Group report. After exploring the issues surrounding hybrid instruments, the Working Group decides not to recommend a codification of an exemption or exclusion for hybrids. The Working Group does recommend legislation to address legal uncertainty with respect to certain hybrid instruments that reference securities, as well as a limitation of the CEA's "exclusive jurisdiction" clause to address potential jurisdictional disputes between the CFTC and other regulators with respect to certain hybrid instruments. The CFTC believes that it may be possible to create a rule providing greater legal certainty, but in recognition of the interests of the SEC and the bank regulatory agencies in this area, agrees not to propose any new rule relating to hybrid instruments without the concurrence of the other members of the Working Group. The other Working Group members agree to work with the CFTC in the development of such a rule.

The final area explored in detail in the report is the provision of the CEA providing the CFTC with "exclusive jurisdiction" over commodity futures. This provision has proven problematic in jurisdictional disputes between the CFTC and other regulatory agencies. The Working Group members all agree that the clause should be modified, and unanimously recommend certain limited changes relating to hybrid instruments. With regard to broader limitations on the exclusive jurisdiction clause, Treasury, the Federal Reserve and the SEC have agreed on specified limitations, but the CFTC has indicated that it requires further study of the implications. However, the CFTC agrees to work with the other agencies to develop its views on a broader modification.

The final section of the report touches on a number of additional issues which the Working Group believes are important to resolve. These issues include single stock futures, regulatory and tax arbitrage, netting, and derivatives dealers:

- With regard to single stock futures, we state that "the current prohibition on single stock futures can be repealed if issues about the integrity of the underlying securities market and regulatory arbitrage are resolved." The Working Group agrees that the SEC and the CFTC should work together and with Congress to resolve whether single stock futures trading should be permitted and, if so, under what conditions.
- For regulatory and tax arbitrage issues, the Working Group concludes that such issues should be addressed by amending underlying statutes and regulations rather than by attempting to use the CEA to resolve such issues. In particular, the report notes Treasury's efforts to address disparities in tax treatments between investments in derivatives versus their underlying instruments.
- On the issue of netting, the Working Group reiterates its support for the improvements recommended in its April 1999 hedge fund report.
- Finally, with regard to derivatives dealers, the Working Group notes that private counterparty discipline is the primary mechanism for achieving the public policy objectives of limiting potential losses from counterparty defaults and reducing systemic risk. The report again recommends that Congress grant enhanced risk assessment authority to the SEC for unregulated affiliates of broker-dealers.

Potential Areas of Controversy

Yesterday, the CFTC raised two major issues concerning the report that have proved difficult to resolve. Either or both of these issues may become the focus of discussion at next Tuesday's principals' meeting.

First, the CFTC objects to excluding standardized swaps from the CEA if there is no opportunity for the parties to negotiate the terms. Second, the CFTC objects to language in the report specifically allowing regulated clearinghouses to clear swaps that are "fungible."

Concerning the first CFTC issue, we are in the process of working with the SEC and the Fed to determine if language that states that electronic trading systems must have a feature which permits participants in the system to negotiate on a bilateral basis the specific terms of a swaps transaction, whether or not it is used, would be acceptable to them. The argument for such a provision is that it retains a distinction between OTC derivatives and futures. The argument against this provision is that it may hinder the development of efficient trading systems for contracts that have become standardized due to the legal necessity to offer this negotiation feature. From a public policy perspective, we do not necessarily see the benefit to recommending such a position.

With regard to the second issue, one possible reason for the CFTC's concern with the word "fungibility" is that they do not want to permit clearinghouses outside of their jurisdiction to permit futures-style offset of contracts. In other words, they do not want a party to take a swaps position with one counterparty and then take an exactly opposite swaps position with another counterparty and thus be able to extinguish both positions and any potential liability. Allowing this may, from their point of view, make the swaps too similar to futures contracts. However, there are benefits, including reduction of systemic risk, in allowing regulated clearinghouses to provide for futures-style offset. We, the Fed, and the SEC believe that the substance of the recommendation should remain intact. However, this is a substantial change from current practice. By forcing this issue, we may be putting Chairman Rainer in a very difficult position.

Another possibility is that the CFTC may be concerned with the use of the word "fungible" in the report because they believe that the Chicago exchanges will be "up in arms" if they see that particular word. But using other words that achieve the same result is unlikely to relieve the concerns of the Chicago exchanges. Ambiguity may not be appropriate, because it would not be a good idea for the report to be ambiguous on a key point and then have it come out in Congressional hearings a few days after the report is released that the agencies have a fundamentally different interpretation of what their report means.

We are continuing to discuss this issue with the CFTC. If it cannot be resolved, there may need to be a footnote in the report that indicates that Chairman Rainer is not in complete accord with the other Working Group members concerning the desirability of clarifying that certain fungible swaps are not subject to the CEA.

Over-the-Counter Derivatives Markets and the Commodity Exchange Act

Report of The President's Working Group on Financial Markets

I. Introduction

Last year, in the Conference Report for the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999, Congress indicated that the Commodity Futures Trading Commission (the "CFTC") should work with the President's Working Group on Financial Markets (the "Working Group")[1] in developing policy with respect to over-the-counter ("OTC") derivative instruments.[2] As a result, the Working Group committed to prepare a report to Congress on issues affecting OTC derivatives. This Working Group report focuses on changes to the Commodity Exchange Act (the "CEA") that are necessary to clarify and enhance the extent to which OTC derivatives transactions may be conducted with legal certainty under the CEA and to remove obstacles to innovation in our financial markets.

The Working Group has concluded that the current legal and regulatory structure must be updated in order to encourage innovation, reduce systemic risk, and maintain U.S. leadership in the markets for derivatives. Specifically, the Working Group is recommending:

- A statutory exclusion from the CEA for certain OTC derivatives and for certain electronic trading systems;
- Enactment of an appropriate system of regulation for clearing systems that clear OTC derivatives transactions;
- A statutory clarification of the Treasury Amendment consistent with its original intent; and
- A modification of the exclusive jurisdiction clause of the CEA.

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1 The Working Group is composed of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Chairman of the Securities and Exchange Commission (the "SEC"), and the Chairman of the CFTC.

2 H. Rep. No. 825, 105th Cong., 2d Sess. 991-92 (1998).

A comprehensive legislative approach is necessary to establish clear Congressional policy with respect to market innovations such as electronic trading and clearing mechanisms for OTC derivatives.

The Working Group is aware that the OTC derivatives markets implicate statutes and regulatory structures other than the CEA. Accordingly, certain additional issues, including the conditions under which the trading of single stock futures contracts might be permitted, are discussed in the last section of the report. Moreover, although this report recommends the enactment of legislation to clearly exclude most OTC derivatives transactions from the CEA, this does not mean that transactions should not, in some instances, be subject to a different regulatory regime or that a need for regulation of currently unregulated activities may not arise in the future. Specifically, although the Working Group recommends excluding certain electronic trading systems for OTC derivatives from the CEA, limited regulation aimed at enhancing market transparency and efficiency may become necessary as such systems develop and grow. The Working Group members will continue to monitor and consider the desirability of regulatory or legislative action to address issues that may arise in the future.

The Working Group looks forward to working with Congress to develop legislation to implement the recommendations contained in this report.

II. Over-the-Counter Derivative Instruments

The market for OTC derivatives has expanded steadily and rapidly over the past two decades. At year-end 1998, the total estimated notional amount of outstanding OTC derivative contracts was $80 trillion, reflecting an increase of 11 percent from June 1998, according to data from the Bank for International Settlements ("BIS"). In contrast, exchange-traded futures and options contracts amounted to just $13.5 trillion at the end of 1998, down almost 6 percent from the end of June 1998.[3]

The exchange-traded and OTC derivatives markets differ in several important respects. Exchange-traded instruments — principally futures and options — are standardized as to their

[3] Bank for International Settlements, Quarterly Review: International Banking and Financial Market Developments (Aug. 1999).

material terms and conditions, whereas the terms and conditions of OTC instruments can be negotiated between the parties to the contract. The customization of these transactions to individual customer needs as to maturity, payment intervals, or other terms allow the customer to adjust individual risk positions with greater precision. Exchange-traded instruments, however, may offer market participants the advantages of greater liquidity, price transparency, and lower credit risk than OTC derivatives. Transactions in the OTC market are generally conducted on a principal-to-principal basis, whereas most exchange transactions are initiated through futures commission merchants ("FCMs") acting as agents for customers. Exchange-traded markets are therefore more accessible to retail customers, whereas the OTC markets tend to be institutional. The OTC derivatives markets are dominated by interest rate and foreign currency products. According to BIS, interest rate and foreign exchange contracts account for the vast majority of these markets (72 percent and 26 percent, respectively); equity-related contracts make up only 2 percent of the market, while tangible commodities account for a fraction of a percent.[4]

Activity in the OTC derivatives market is primarily concentrated in three types of instruments: swap agreements, options, and hybrid instruments.[5] The typical swap agreement involves a contract between two parties to exchange a series of payments determined by reference to the difference between the rate or price of an agreed-upon amount (known as the "notional" amount) of some underlying asset prevailing on specified dates during the term of the swap agreement and the fixed rate or price specified in the swap agreement. Because the notional amount of a swap agreement is only a contractual term used to calculate payments under the swap agreement, it generally is not exchanged between the parties to the agreement.

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[4] Bank for International Settlements, Press Release, The Global OTC Derivatives Market at End-December 1998 (June 2, 1999).

[5] The terminology used to describe derivative instruments is not always used with precision. Certain complex derivative instruments (sometimes referred to as "swaptions") combine the characteristics of both typical swaps and options, and the term "swap" is often used to refer collectively to typical swaps, options, and instruments that combine characteristics of both. Similarly, the term "OTC derivative" is usually meant to refer to all of these instruments and sometimes is meant to refer to hybrid instruments as well, although hybrid instruments are frequently listed for trading on securities exchanges and issued in standardized tranches and therefore may not be traded over-the-counter.

An option is an instrument that provides the holder with the right, but not the obligation, to buy (call option) or sell (put option) a specified amount or value of a particular underlying interest at a specified price on or before its specified expiration date. Typically, OTC options provide for cash settlement, rather than delivery of the underlying asset, or a choice between the two methods of settlement.

Hybrid instruments are depository instruments (i.e., demand deposits, time deposits or transaction accounts) or securities (i.e., debt or equity securities) that have one or more components with payment features economically similar to swaps, forwards, options, or futures contracts.

III. Legal Certainty (Enforceability of Contracts)

Legal certainty is a crucial consideration when parties to OTC derivative contracts decide with whom and where to conduct their business. Parties need to be certain that the contracts into which they enter are permissible in the governing jurisdiction, that their counterparties have the legal capacity to enter into the contracts, and that the provisions of the contracts are enforceable. An environment of legal certainty for OTC derivatives and their execution and clearing will help to reduce systemic risk in the U.S. financial markets and enhance the competitiveness of the U.S financial sector.

For OTC derivative contracts, uncertainty arises from concerns as to whether some of these contracts could be construed to be subject to the CEA and whether certain types of mechanisms for executing and clearing OTC derivatives might be construed to alter the legal status of otherwise exempted or excluded instruments. These concerns have already begun to inhibit financial institutions from developing and offering new instruments and new initiatives to manage risk and have the potential to reduce the flexibility and competitiveness of U.S. financial markets. In light of the size of the market and its importance to the U.S. economy, to other markets, and to U.S. financial institutions, these concerns should be addressed.

The CEA subjects contracts for the sale of a commodity for future delivery and options on such contracts to the exclusive jurisdiction of the CFTC.[6] The CFTC also has jurisdiction

[6] 7 U.S.C. § 2(i). The CEA also provides that the term "future delivery" does not include any sale of any cash commodity for deferred shipment or delivery. 7 U.S.C. § 1a(11).

over commodity option contracts, although the CEA does not unambiguously characterize the CFTC's jurisdiction over such instruments as exclusive.[7] In addition, transactions in, or in connection with, commodity futures contracts and commodity options contracts must be conducted in accordance with the CEA and regulations promulgated by the CFTC. In general, this means that, subject to certain administrative exemptions currently granted by the CFTC, transactions must be conducted on, or subject to the rules of, a contract market designated by the CFTC.[8] The CEA defines "commodity" to include specific agriculture commodities and "all other goods and articles, ... and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."[9]

In 1974, Congress amended the CEA to state that "[n]othing in this Act shall be deemed to govern or in any way be applicable to transactions in foreign currency, securities warrants, securities rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade."[10] This statutory exclusion, known as the "Treasury Amendment," was enacted at the request of the Department of the Treasury ("Treasury") as part of the same act that expanded the definition of "commodity" from a list of specific tangible products to the broad definition contained in current law. As discussed in more detail below, however, the exact scope of the exclusion has been the subject of litigation.

Uncertainties concerning the jurisdictions of the CFTC and the SEC to regulate certain securities-based derivatives instruments arose from the amendments to the CEA enacted in 1974 that gave the CFTC exclusive jurisdiction over all futures, whether the underlying instrument was a physical commodity or a financial commodity.[11] The same amendments provided, however, that the jurisdiction of the SEC was not otherwise superseded or limited. These

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[7] 7 U.S.C. §§ 2, 6c. <u>But see</u> S. Rep. 93-1131, 93d Cong. 2d Sess., <u>reprinted in</u> 1974 U.S.C.C.A.N. 5843, 5870; <u>International Trading Ltd. v. Bell</u>, 556 S.W.2d 420 (Ark. 1977), <u>cert. Denied</u>, 436 U.S. 956 (1978).

[8] 7 U.S.C. § 6(a), 6c.

[9] 7 U.S.C. § 1a(3).

[10] 7 U.S.C. § 2(ii).

[11] 7 U.S.C. § 2(i).

provisions have created conflicts regarding each agency's jurisdiction over novel financial instruments that have elements of securities and futures or commodity options contracts.

In an attempt to clarify the scope of the CEA and to permit the trading of stock index futures, the SEC and the CFTC agreed to specify which financial instruments fell within each agency's jurisdiction. This agreement, known as the Shad-Johnson Accord, was codified by Congress in 1982 through amendments to the CEA and the federal securities laws.[12] The Shad-Johnson Accord amended the CEA to explicitly prohibit futures contracts based on the value of, or any interest in, an individual security (other than certain "exempt securities"),[13] or a securities index that does not satisfy the statute's criteria as to the composition of the index. The Shad-Johnson Accord also gives the SEC authority over options on (i) securities (including exempted securities), (ii) certificates of deposit, (iii) foreign currencies traded on a national securities exchange, and (iv) groups or indices of securities; and gives the CFTC authority over futures contracts and options on futures contracts on (i) exempt securities (other than municipal securities), (ii) certificates of deposit, and (iii) indices of securities that satisfy the statute's criteria.

To address concerns about the legal status and enforceability of OTC derivative contracts, the Futures Trading Practices Act of 1992 (the "FTPA") amended the CEA to provide the CFTC with authority to grant exemptions from the CEA for any transaction or class of transactions that meets certain criteria.[14] The FTPA did not specifically address whether or not any particular type of transaction, such as a swap agreement, is a futures contract or an option. The Conference Report language, in fact, made clear that the CFTC could grant an exemption without finding

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12 Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 (1983); Act of Oct. 13, 1982, Pub. L. No. 97-303, 96 Stat. 1409.

13 "Exempt securities" include government securities and certain other securities that are exempt from many of the federal securities laws pursuant to Section 3(a)(2) of the Securities Act or Section 3(a)(12) of the Securities Exchange Act. Although municipal securities are exempt securities under the securities laws, under the Shad-Johnson Accord they are treated like corporate debt and equity securities, foreign sovereign debt securities, and other securities that are not classified as exempt securities under the securities laws. Thus, municipal securities and other securities that are not defined as exempt securities are collectively referred to as "non-exempt securities" in this report.

14 Futures Trading Practices Act of 1992, Pub. L. No. 102-546, 106 Stat. 3590.

that the transaction is a futures contract subject to the CEA.[15] To grant an exemption, the CFTC must determine that the exemption is in the public interest, that the exempted transactions will be entered into only by "appropriate persons," and that the exemption will not have a material adverse effect on the ability of the CFTC or a designated contract market to fulfill its duties under the CEA.[16] Further, the FTPA expressly precluded the CFTC from exempting transactions from the Shad-Johnson Accord, including the prohibition of futures contracts on an individual non-exempt security. This limitation, coupled with Congress's decision to authorize an exemption (rather than an exclusion) for swap agreements, is the origin of concern about the legal status of certain swap agreements that reference securities.

Since 1992, the CFTC has used its exemptive authority in connection with each of the three classes of instruments that were specifically discussed in the legislative history of the FTPA: (1) swap agreements; (2) hybrid instruments; and (3) certain OTC energy contracts, including Brent oil contracts, which had been found by one court to be futures contracts.[17] In exercising its authority, the CFTC also reaffirmed the continued applicability of its Policy Statement Concerning Swap Transactions (the "Policy Statement") and Statutory Interpretation Concerning Certain Hybrid Instruments, statements of regulatory and enforcement policy with respect to swap agreements and hybrid instruments that had been issued by the CFTC prior to the enactment of the FTPA.[18]

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[15] H.R. Rep. No. 102-978, 102d Cong, 2d Sess. 83 (1992).

[16] 7 U.S.C. § 6(c). Under the FTPA, "appropriate persons" include banks, insurance companies, investment companies, commodity pools, broker-dealers, futures commission merchants, and governmental entities. A corporation or partnership may be an appropriate person if it has a net worth exceeding $1,000,000 or assets exceeding $5,000,000. The CFTC may determine that the inclusion of other persons is appropriate based on financial or other qualifications or on the application of appropriate regulatory protections.

[17] 17 C.F.R. pt. 35; 17 C.F.R. pt. 34; Exemption for Certain Contracts Involving Energy Products, 58 Fed. Reg. 21286 (Apr. 20, 1993). Cf. Transnor (Bermuda) Ltd. v. BP N. Am. Petroleum, 738 F. Supp. 1472 (1990).

[18] Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30694 (July 21, 1989); Statutory Interpretation Concerning Certain Hybrid Instruments, 55 Fed. Reg. 13582 (Apr. 11, 1990).

IV. Swap Agreements: Continuing Legal Uncertainties and Working Group Recommendations

As a result of limitations in the FTPA and the continuing evolution of the OTC markets, concerns regarding legal uncertainty persist. While the Working Group believes that the range of OTC derivatives activity currently conducted in the United States generally does not fall within the category of transactions intended to be regulated (or prohibited) as futures or options contracts under the CEA, the Working Group nonetheless recognizes that any reasonable uncertainty can have undesirable effects and should be remedied. Moreover, uncertainty involving OTC derivatives has hampered private sector efforts to utilize electronic trading systems to enhance market efficiency and clearing initiatives to reduce systemic risk in the OTC markets. Accordingly, the Working Group believes that a series of amendments to the CEA is necessary in order to enhance legal certainty, mitigate risk, and maintain U.S. leadership in the OTC derivatives markets.

A. Current Treatment of Swaps under the CEA

In 1989, the CFTC issued the Policy Statement, which reflected the agency's view that "most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the [CEA] and regulations."[19] Because the Policy Statement was issued prior to the enactment of the FTPA, the CFTC at the time lacked authority to exempt futures contracts from the provisions of the CEA that require all such contracts to be traded on contract markets approved by the CFTC. Accordingly, some market participants have

[19] 54 Fed. Reg. at 30694. The Policy Statement created a non-exclusive safe harbor that the CFTC indicated it would recognize. To qualify for this safe harbor, swap transactions must, among other things, be settled in cash or foreign currency, have "transaction specifications" that are "individually tailored," be "based upon individualized credit determinations," and not be subject to termination by an exchange-style offset mechanism nor "supported by the credit of a clearing organization" or "a mark-to-market margin and variation settlement system designed to eliminate individualized credit risk." Also, to qualify for the non-exclusive safe harbor, swap transactions must be connected to the "parties' line of business" (which may include providing financial intermediation services) and cannot be marketed to the public.

indicated that they viewed the Policy Statement as an indication that swap agreements covered by the Policy Statement are not futures contracts.[20]

In enacting the FTPA in 1992, Congress indicated that the CFTC should use its authority to exempt swap agreements from the CEA "to the extent that such agreements may be regarded as subject to the provisions of [the CEA]."[21] Thus, while Congress clearly indicated that swap agreements should not be regulated under the CEA, it did not establish whether swaps are commodity futures or options that would be subject to the CEA in the absence of an exemption. In 1993, the CFTC adopted an exemption for swap agreements (the "Swap Exemption").[22] A swap agreement meeting the following criteria falls within the scope of the exemption:

- The swap agreement must be entered into between eligible swap participants. "Eligible swap participants" are defined to include various regulated financial institutions, business enterprises that meet certain tests relating to total assets or net worth, certain pension funds, state and local governments, and individuals with more than $10 million in total assets.
- The swap agreement may not be part of a fungible class of agreements that are standardized as to their material economic terms.
- The creditworthiness of the parties to the swap agreement must be a material consideration in entering into and determining the terms of the swap agreement.
- The swap agreement may not be entered into and traded on or through a multilateral transaction execution facility (an "MTEF").

Although the Swap Exemption affords practical relief for a broad range of transactions, concerns about its scope persist. Because Congress never conclusively determined whether swaps would be subject to the CEA in the absence of the exemption, the exact status of these instruments (i.e., whether they are forwards, futures, options, or none of the above) is unclear.

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20 The CFTC did have exemptive authority for commodity options at that time, although the Policy Statement did not expressly exercise this authority with respect to options. By its terms, the Policy Statement is also applicable to swap agreements that may be options.

21 7 U.S.C. § 6.

22 Exemption for Certain Swap Agreements, 58 Fed. Reg. 5587 (Jan. 22, 1993) (codified at 17 C.F.R. pt. 35).

Under the Swap Exemption, the CFTC retains anti-fraud and anti-manipulation authority over otherwise exempted swap agreements. It is arguable, however, that this retained authority would be available only in instances where swap agreements actually are commodity futures or options or, in the case of anti-manipulation authority, where they are used to manipulate the cash or futures market for a commodity.

Moreover, actions by the CFTC in the past led some market participants to express concerns that the CFTC would modify the Swap Exemption and attempt to impose significant new regulations on the swap market. In a comment letter opposing the SEC's "broker-dealer lite" proposal,[23] the CFTC stated that the SEC's proposal extended beyond the jurisdiction of the SEC to regulate securities and would create the potential for conflict with the requirements of the CEA.[24] The letter states that many OTC derivative instruments fall within the ambit of the CEA and are subject to the exclusive statutory authority of the CFTC.

In addition, the CFTC issued a concept release requesting comment on whether regulation of the OTC derivatives market is appropriate and what form such regulation should take.[25] The concept release gave rise to uncertainty as to the applicability of the Swap Exemption to certain aspects of the developing OTC markets, because it asserted that products were becoming increasingly standardized and that the use of electronic systems for central execution or clearing might remove transactions from the coverage of the Swap Exemption. The CFTC's concept release was particularly unsettling to participants in the market for swap agreements that reference non-exempt securities — such as some equity swaps, credit swaps, and emerging market debt swaps — because statements implying that some swap agreements might be viewed as futures contracts carried the additional implication that some swaps (those that might be viewed as futures contracts) involving non-exempt securities might be illegal. This is the case

[23] OTC Derivatives Dealers, 63 Fed. Reg. 59362 (Nov. 3, 1998). As adopted by the SEC, this rule provides OTC derivative dealers affiliated with registered broker-dealers with an alternative regulatory regime in order to facilitate participation by such dealers in the OTC derivatives markets. Under the rule, an OTC dealer is permitted to engage in OTC derivatives transactions that qualify as securities, as well as transactions in non-security OTC derivatives, subject to capital requirements that would be more favorable to such transactions than the traditional broker-dealer regulatory regime.

[24] Letter from Jean A. Webb, Secretary, CFTC, to Jonathan G. Katz, Secretary, SEC (Feb. 26, 1998).

[25] Over-the-Counter Derivatives, 63 Fed. Reg. 26114 (May 12, 1998).

because the Shad-Johnson Accord prohibits futures on non-exempt securities (except futures on securities indices on designated contract markets that are cash settled and meet certain other conditions), and the CFTC cannot grant exemptions from the restrictions of the Shad-Johnson Accord.

Swap agreements involving non-exempt securities are routinely entered into, however, in reliance on the CFTC's statement in the Policy Statement that most swap transactions are not appropriately regulated as commodity futures or options. As noted above, some market participants understood this statement to reflect an indication that swaps covered by the Policy Statement are not commodity futures. Moreover, in adopting the Swap Exemption, the CFTC stated that market participants could continue to rely on the Policy Statement.[26]

Legislation enacted at the request of Treasury, the Federal Reserve, and the SEC in 1998 limited the CFTC's rulemaking authority until March 30, 1999 and froze the pre-existing legal status of swap agreements entered into in reliance on the Policy Statement.[27] The legislation lessened the legal uncertainty resulting from the CFTC's concept release, but did not provide a permanent clarification of the legal status of these instruments.

B. Electronic Trading Systems

Technological innovation in the financial markets in recent years has been significant, and it is likely that the pace of change will accelerate in the future. Computer technology has the potential to increase the efficiency and liquidity of the financial markets by increasing the speed of transactions and lowering transaction costs. At the same time, new ways of doing business present new questions about the applicability of existing laws.

Both exchange-traded derivatives markets and the OTC markets have begun to make use of new technologies. Both the Chicago Board of Trade and the Chicago Mercantile Exchange had introduced electronic trading systems (known as Project A and Globex, respectively) that

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[26] 58 Fed. Reg. 5587, 5588 (Jan. 22, 1993). In referring to the Policy Statement, the CFTC cited FTPA legislative history stating that Congress did not intend to call into question the legal status of existing securities-linked swaps.

[27] Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act, 1999, § 760, as enacted in Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999, Pub. L. No. 105-277, 112 Stat. 2681, 2681-35 (1998).

operate in conjunction with the exchanges traditional floor-trading activities. In the OTC market for foreign currency derivatives (which are excluded from the CEA by the Treasury Amendment), electronic trading systems owned by Reuters Transaction Services Limited and EBS Service Company Limited have successfully operated for several years. More recently, an electronic system for interest rate and currency swaps has been developed by DNI Holdings Inc.

The development of computerized trading systems for OTC derivatives, however, has been affected by uncertainty about the applicability of the CEA. Swap agreements are not currently covered by the Swap Exemption if they are entered into and traded on or through an MTEF. The CFTC has explained that an MTEF "is a physical or electronic facility in which all market makers and other participants have the ability to execute transactions and bind both parties by accepting offers which are made by one member and open to all members of the facility."[28] The applicability of this definition to particular systems that may be developed is far from clear, however.

Traditionally, participants in the swap market have communicated bid and offer information and entered into swap agreements via telephone and facsimile. Computer technology, however, can allow market participants to communicate with multiple parties at the same time via computer terminals, and to execute transactions automatically. The CFTC has indicated that although electronic communication systems would not be MTEFs, systems used to enter orders to execute transactions may be MTEFs.[29] Market participants, however, have argued that the means used to execute a swap agreement (computer systems rather than telephonic systems) should not alter the regulatory status of the agreement. Market participants have also argued that an electronic system in which the credit policies of each participant are programmed into the system is not an MTEF, because an offer made by one participant would only be open to other participants with credit that was deemed acceptable by the offeror. On the other hand, representatives of organized futures exchanges have argued that electronic systems that allow for automated execution operate as exchanges and should be regulated in a similar manner.

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[28] 58 Fed. Reg. at 5591.

[29] Id.

C. Clearing Systems

Clearing systems can mitigate the loss that an individual party to a transaction suffers if its counterparty fails to settle an obligation. In a clearing system, obligations of the counterparties are discharged and replaced by obligations of a central counterparty or by obligations of other participants in the system. Often clearing systems also entail a system for sharing losses among surviving participants or for shifting losses to a third party. Thus, clearing systems can serve a valuable function in reducing systemic risk by preventing the failure of a single market participant from having a disproportionate effect on the overall market. Because they may serve to concentrate diffuse credit risks in a single entity, however, clearing systems should be subject to regulatory oversight in order to help ensure that proper risk management procedures are established and implemented and that the clearing system is properly structured.

By its terms, the Swap Exemption "does not extend to transactions that are subject to a clearing system where the credit risk of individual members of the system to each other in a transaction to which each is a counterparty is effectively eliminated and replaced by a system of mutualized risk of loss that binds members generally whether or not they are counterparties to the original transaction."[30] The CFTC has indicated, however, that a person seeking to establish a clearing system for swaps might apply for a further exemption from the CEA to allow a system to operate in an environment of legal certainty.[31]

Some market participants have been critical of the CFTC's response to various clearing initiatives in the past. In its concept release, the CFTC sought comment on proposed regulatory approaches to clearing systems, thereby implicitly asserting regulatory jurisdiction over OTC market clearing without articulating a clear statutory basis for doing so.[32] Moreover, questions raised by the CFTC in the context of filings by Delta Clearing Corp. and Government Securities Clearing Corp. ("GSCC") in connection with proposals to clear certain products involving government securities,[33] as well as the explicit limitations on clearing in the Policy Statement

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[30] 58 Fed. Reg. at 5591.

[31] Id. at 5591 n.30.

[32] 63 Fed. Reg. at 26122.

[33] See Securities Exchange Act Release No. 39623, 63 Fed. Reg. 7022 (Feb. 11, 1998); Securities Exchange Act Release No. 40623, 63 Fed. Reg. 59831 (Nov. 5, 1998).

and Swap Exemption, have constrained the development of initiates to expand the use of clearing facilities in the OTC markets.

The Working Group notes that the CEA does not provide for direct oversight of clearing systems by the CFTC. Rather, CFTC regulation of the clearing function arises as part of the CFTC's oversight of a clearing system's associated futures exchange. As a result, the CEA includes no provision or framework for the oversight of a clearing system for OTC derivatives. In addition, as evidenced by the questions raised in the context of GSCC and Delta, the introduction of clearing systems can give rise to complex jurisdictional issues that must be resolved. Accordingly, the Working Group believes that Congressional action is necessary to establish appropriate policy guidance for the establishment and oversight of clearing systems for OTC derivatives.

D. Recommendations

1. Reinforcing Legal Certainty for Swaps

All of the Working Group members agree that there has been no need demonstrated for additional regulation of bilateral swap agreements between institutional counterparties. Accordingly, the Working Group recommends:

- Bilateral swap agreements (including those that reference non-exempt securities) entered into by eligible swap participants, on a principal-to-principal basis, should be excluded from the CEA, provided that the transactions are not conducted on an MTEF. Certain types of electronic trading systems described below would, however, also be excluded from the CEA.
- [[Because the material economic terms of many swap agreements are similar, the requirement that swap agreements not be standardized as to their material economic terms would be [eliminated] [replaced with a requirement that the material economic terms of the agreement be subject to potential negotiation by the parties to the transaction; provided, however, that the excluded status of the agreement would not be affected by the extent to which negotiation does or does not occur.] [The requirement that material economic terms of the agreement be subject to potential negotiation would be satisfied by negotiation of the terms of a

master agreement to cover subsequent transactions entered into by the parties to the master agreement.]]

- As discussed below, the Working Group is recommending that clearing of swap agreements be permitted, subject to appropriate regulatory oversight of the clearing function. Accordingly, insofar as transactions are subject to regulated clearing, the exclusion would not [prohibit [fungibility] [offsetting of contractual obligations through the clearing system] or] require that creditworthiness be a material consideration.
- The exclusion would not extend to any swap agreement to the extent that it is a future or an option on an agricultural commodity.[34]
- The exclusion would only cover swaps between eligible swaps participants (defined in a manner similar to the definition in the current Swap Exemption). Thus, the exclusion would only be available for regulated financial institutions, business enterprises that meet certain tests relating to total assets or net worth, certain pension funds, state and local governments, and individuals with significant assets. Consideration should be given to further restricting the extent to which individuals qualify for the exclusion by not making it available to natural persons who own and invest on a discretionary basis less than $10 million in investments.
- The CEA should be amended to clarify that a party to a transaction may not avoid performance of its obligations under, or recover losses incurred on, a transaction based solely on the failure of that party (or its counterparty) to comply with the terms of an exclusion or exemption under the CEA.
- To the extent that OTC derivatives transactions between eligible swap participants are excluded from the CEA, they should also be excluded from the coverage of certain state laws (such as laws designed to regulate gambling or bucket shops) that might be construed to prohibit or inappropriately regulate such transactions.

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[34] The CFTC would retain its current exemptive authority for these derivatives.

Because swap agreements would only qualify for the statutory exclusion if entered into between eligible swap participants on a principal-to-principal basis, concerns about protection of retail investors would not exist. In addition, most of the dealers in the swaps market are either affiliated with broker-dealers or futures commission merchants ("FCMs") that are regulated by the SEC or the CFTC or are financial institutions that are subject to supervision by bank regulatory agencies. Accordingly, the activities of most derivatives dealers are already subject to direct or indirect federal oversight. To ensure that the unregulated affiliates of broker-dealers and FCMs are subject to appropriate regulatory scrutiny, however, the Working Group reiterates the recommendation made in its report on hedge funds concerning enhanced risk assessments of these affiliates.[35]

Due to the special characteristics of the markets for agricultural products, however, the Working Group is recommending that the exclusion not be extended to agreements involving agricultural commodities. Because agricultural production is seasonal and volatile, and the underlying commodity is perishable, the markets for these products are susceptible to supply and pricing distortions, and may be more susceptible to manipulation. Moreover, the cash market for agricultural commodities is dependent on the futures market for price discovery. The CFTC should, however, retain its current exemptive authority for agricultural derivatives, and should grant exemptions in instances where they are in the public interest and otherwise consistent with the CEA.

2. Electronic Trading Systems

The Working Group members agree that legal uncertainty should not be permitted to hinder technological innovation in the OTC derivatives market. The introduction of electronic trading systems for OTC derivatives has the potential to promote efficiency and transparency, and, by enabling firms that participate in the systems to impose more reliable internal controls on their traders, to reduce risks. Accordingly, the Working Group recommends that Congress

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[35] President's Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management 38-40 (Apr. 1999). As was the case in the report on hedge funds, Chairman Greenspan of the Federal Reserve declines to endorse the recommendation for expanding risk assessment for the unregulated affiliates of broker-dealers and FCMs, but, in this instance, defers to the judgment of those with supervisory responsibility.

amend the CEA to clarify that entering into or trading excluded swap agreements (i.e., agreements between eligible swap participants) through electronic trading systems with certain characteristics does not affect the status of the agreements traded through the system and does not provide a basis for regulation of the system.

- Permitted electronic trading systems would include systems that are clearly not covered by the definition of MTEF in the current Swap Exemption. For example, electronic systems that assist eligible swap participants in communicating about or negotiating a bilateral agreement would be permitted.
- In addition, permitted electronic trading systems would include any form of electronic trading system (including one in which bids and offers are open to all participants) that meets the following tests:
  - participants may act solely for their own account; and
  - the system may not be used to enter into agreements under which a party may be required to make physical delivery of a non-financial commodity with a finite supply.
- [[To qualify for an exclusion, an electronic trading system would be required to provide a means by which the material economic terms of the agreements traded on the systems could be subject to potential negotiation by the parties to a transaction; provided, however, that the excluded status of an agreement and the system would not be affected by the extent to which negotiation does or does not occur.] [The requirement that material economic terms of agreements traded on the system be subject to potential negotiation would be satisfied by negotiation of the terms of a master agreement to cover subsequent transactions entered into by the parties to the master agreement.]]
- Exchanges that have been designated as contract markets by the CFTC would be permitted to establish these types of unregulated trading systems for qualified swaps.

The Working Group believes that there is not a demonstrable need for regulation of the systems described above at this time. Many electronic trading systems for derivatives are only just beginning to emerge, and the markets should be allowed to grow, unburdened by an anticipatory regulatory structure that could prove entirely inappropriate to the eventual evolution of such markets.

The Working Group believes, however, that a broad exclusion should be available only for systems in which participants trade for their own account, rather than as agents. As a result, systems that develop to take advantage of the exclusion would be accessible only to participants who are dealers or otherwise active in the market on a daily basis. This would provide added assurance of the sophistication of parties eligible to transact on the system (all of whom must, of course, also be eligible swap participants), and would also help to limit the significance of electronic trading systems vis-à-vis regulated exchanges and cash markets. The limitation would also restrain potential market abuses such as front-running that might otherwise arise.

The Working Group also believes that a broad exclusion should not be available for systems to trade agreements that require physical delivery of a non-financial commodity with a finite supply (such as agricultural products, precious metals, and energy products), because of concerns about the possibility of manipulation in the markets for such commodities.[36] By contrast, markets for financial derivatives such as interest rate swaps are extremely deep and liquid and therefore are not readily susceptible to manipulation.

The Working Group notes that its recommendation to exclude certain trading systems from the CEA should not be viewed as a determination that regulation of these systems may never be appropriate. Limited regulation aimed at enhancing market transparency and price discovery may become necessary as electronic trading systems for OTC derivatives develop and grow, if problems of the sort that are appropriately addressed by regulation emerge. At this time, however, it is better to encourage the development of these systems by providing greater legal certainty than to attempt to anticipate an appropriate regulatory scheme for market innovations that are still in the initial stages of development and implementation.

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[36] The CFTC would, however, retain authority to exempt any system that does not qualify for the statutory exclusion.

U.S. futures exchanges have commented that they believe that they are at a competitive disadvantage to the OTC derivatives market as the result of CEA regulation, and that electronic trading systems have the potential to worsen the perceived imbalance. The Working Group believes that its proposals help to bring parity to the regulatory requirements, since the futures exchanges, under the Working Group's proposals, could set up unregulated electronic trading systems under the same conditions as their competitors.

In addition, the CFTC is currently reviewing a petition from the futures exchanges for regulatory relief for their floor-traded contracts. While we cannot prejudge the result of the CFTC's determinations concerning the petition for regulatory relief, under current law the CFTC has the authority to grant such relief if it determines it is in the public interest. The Working Group as a whole supports the CFTC's initiative in considering whether some of the regulatory requirements on futures exchanges are no longer necessary and may put them at an unfair competitive disadvantage.

3. Clearing Systems

The Working Group recommends that Congress enact legislation to provide a clear basis for the regulation of clearing systems that may develop for OTC derivatives. In this context, a clearing system would be defined as a system in which the obligations of counterparties to a transaction are discharged and replaced by obligations of a central counterparty or by obligations of other participants in the system, including participants that were not the original counterparties to the transaction. Legislative action would have the beneficial effects of encouraging the development of such systems by clarifying their legal status, subjecting them to appropriate supervision, and ensuring that U.S. firms, initiatives, and markets are not at a competitive disadvantage relative to their foreign counterparties. The Working Group believes that a comprehensive regulatory framework should contain the following features:

- provisions authorizing clearing organizations that clear futures, commodity options, and options on futures also to clear OTC derivatives (other than OTC derivatives that are securities, such as securities options), subject to the oversight of the CFTC;

- provisions authorizing securities clearing agencies (which are subject to the oversight of the SEC) also to clear OTC derivatives (other than instruments under which a party may be required to make physical delivery of a non-financial commodity with a finite supply);
- provisions that would authorize the CFTC to develop rules for the establishment and regulation of clearing systems for OTC derivatives involving agricultural products and OTC derivatives under which a party may be required to make physical delivery of a non-financial commodity with a finite supply;[37]
- provisions to require all other clearing systems for OTC derivatives to organize as a bank or Edge Act corporation that would be subject to the supervisory jurisdiction of the Federal Reserve or the Office of the Comptroller of the Currency;
- provisions to establish that a clearing system subject to regulation by one agency would not become subject to regulation by another agency as a result of clearing OTC derivatives;
- provisions to explicitly establish that clearing systems are not, and do not imply the presence of, MTEFs, and that an electronic trading system that is excluded from the CEA does not become subject to the CEA because transactions entered into through the trading system are also cleared;
- provisions to allow clearing through foreign clearing systems that are supervised by a foreign financial regulator that a U.S. regulator has determined satisfies appropriate standards.

V. The Treasury Amendment

A. Background

[37] Note, however, that as discussed above, the CFTC would have authority to determine the conditions under which OTC derivatives based on agricultural products would be permitted, and authority to determine the conditions under which electronic trading would be permitted for OTC derivatives under which a party may be required to make physical delivery of a non-financial commodity with a finite supply.

Treasury proposed the Treasury Amendment in 1974 because of a concern that the very broad definition of the term "commodity" in the Commodity Futures Trading Commission Act would subject the OTC markets for government securities and foreign currency to regulation under the CEA. In the absence of the Treasury Amendment (or another applicable exemption or exclusion), any futures contract involving foreign currency or government securities would be illegal unless traded on a contract market approved by the CFTC.

There are several rationales for this exclusion from the CEA. The main participants in the foreign currency markets are largely sophisticated institutions, such as commercial and investment banks, central banks, foreign exchange dealers, corporations, and pension and mutual funds, that are well-informed and do not need protection. The market is highly efficient and has served the needs of the international business community well. Similarly, the government securities market is one of the most efficient markets in the world and has served the Treasury and the taxpayers well. Moreover, since 1986, government securities have been regulated under the Government Securities Act, and government securities transactions are subject to the anti-fraud and anti-manipulation provisions of the federal securities laws. These markets serve important macroeconomic functions that are best served by minimal regulation.

Unfortunately, the language of the Treasury Amendment, while helpful, has continued to provoke debate and litigation concerning the breadth of the exclusion it provides from the CEA. Prior to 1997, there was a disagreement as to whether foreign currency options were "transactions in" foreign currency that were excluded from the CEA. In 1997, the Supreme Court clarified that the phrase "transactions in" as used in the Treasury Amendment includes options.[38]

There has also been legal uncertainty associated with the so-called "unless clause" of the Treasury Amendment, which provides that the CEA exclusion for transactions in government securities, foreign currency, and the other listed instruments is available "unless such transactions involve the sale thereof for future delivery conducted on a board of trade." The CEA broadly defines "board of trade" to mean "any exchange or association of persons who are engaged in the

38 Dunn v. CFTC, 519 U.S. 465 (1997).

business of buying or selling any commodity."[39] An overly expansive application of this definition could nullify the Treasury Amendment, because even parties to a bilateral contract could be deemed an association of persons engaged in buying and selling. Because a court will generally not interpret a statutory provision in a manner that renders it meaningless, Treasury has argued that the term, as used in the Treasury Amendment, should be viewed solely as a means of preserving the CFTC's authority to regulate transactions that occur on organized futures exchanges.

The CFTC, however, has expressed concerns that the Treasury Amendment may be construed to limit its authority to take enforcement action against "bucket shops" that enter into fraudulent foreign currency transactions with members of the general public. In several enforcement actions it has taken the position that the Treasury Amendment should be interpreted in light of its legislative history, which focused on the need to shelter institutional OTC markets from regulation under the CEA. Thus, the CFTC has argued that an "association of persons" in the institutional market is not a board of trade, but an "association of persons" entering into transactions with the general public is a board of trade.[40]

The case law on the subject is inconclusive. The only Court of Appeals that has addressed this question reached a decision that is generally consistent with Treasury's interpretation.[41] Similarly, one judge of the District Court for the Southern District of New York has interpreted "board of trade" to mean "organized futures exchange" in a case involving transactions between a wealthy individual and an investment bank, but another judge on the same court has adopted a more expansive interpretation of the term board of trade in a case involving a retail bucket shop.[42]

From a policy perspective, these conflicting interpretations of the Treasury Amendment create a "Catch-22" situation. On the one hand, because the text of the Treasury Amendment

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39 7 U.S.C. 1a.

40 See, e.g., In re: Global Link Miami Corp., CFTC Docket No. 98-1 (May 24, 1999).

41 CFTC v. Frankwell Bullion Ltd., 99 F.3d 299 (9th Cir. 1996).

42 Compare Kwiatkowski v. Bear Stearns Co., 1997 U.S. Dist. LEXIS 13078 (Aug. 28, 1997) with Rosner v. Korbean International Investment Corp., 1998 U.S. Dist. LEXIS 7353 (May 18, 1998).

makes no specific reference to the institutional market, there is a risk that a broad interpretation of "board of trade" in a case involving a bucket shop could later be applied to invalidate legitimate transactions in the institutional OTC market. On the other hand, construing the term to preserve only the CFTC's authority over organized futures exchanges that trade instruments covered by the Treasury Amendment impairs the CFTC's ability to take enforcement action in cases involving retail fraud.

Uncertainty has also been expressed with respect to screen-based electronic trading systems and clearing systems for Treasury Amendment instruments. Market participants have expressed the concern that the development of such entities may be hampered by the possibility that they would be considered "boards of trade."

B. Recommendations

The Working Group members recommend that the Treasury Amendment be clarified to confirm its original intent by replacing the term "board of trade" with the term "organized exchange." To address the problem of foreign currency "bucket shops," the Working Group also recommends that the CEA be amended to provide that transactions in foreign currency futures and options are subject to the CEA if they are entered into between a retail customer and an entity that is neither regulated or supervised by the SEC or a federal banking regulator nor affiliated with an entity that is regulated or supervised.

The clarification would preserve the CFTC's authority to regulate transactions in Treasury Amendment instruments that occur on futures exchanges and would provide it with additional authority over certain retail foreign currency transactions, but would clarify that all other transactions in Treasury Amendment products are excluded from the CEA. As would be the case for excluded swaps, regulated clearing of Treasury Amendment products would be allowed without affecting the exclusion from the CEA.

VI. Hybrid Instruments

A. Background

The CFTC's Hybrid Instrument Rule exempts securities and bank deposits that have some of the characteristics of commodity futures or options from all of the provisions of the

CEA except the Shad-Johnson Accord.[43] To qualify for the exemption, a hybrid instrument must derive more than fifty percent of its value (as determined by a calculation methodology specified in the exemption) from aspects of the instrument that are not related to the value of commodities, must be subject to securities or banking laws and sold to persons eligible to purchase the instrument under such laws, and must satisfy certain criteria regarding marketing, payment terms, and settlement. The purpose of the fifty percent test is to limit the extent to which hybrid instruments can be used as substitutes for exchange-traded futures and options. In adopting the Hybrid Instrument Rule, the CFTC did not assert that it retained anti-fraud or anti-manipulation jurisdiction over instruments that are within the scope of the exemption.

Market participants have generally been satisfied that the exemption provides a sufficient measure of legal certainty to the markets for the covered instruments. Nevertheless, the Hybrid Instrument Rule has been criticized by some because of its complexity and because it may cause the legal status of particular classes of instruments to change as commodity prices change. Thus, although an instrument that qualifies for the protection of the Hybrid Instrument Rule when it is issued would not fall outside of the exemption due to changes in commodity prices, an identical instrument issued at a later date might not qualify.

Last year, the CFTC's concept release sought comment on whether the Hybrid Instrument Rule should be amended to expand the CFTC's jurisdiction over exempted instruments. Since hybrid instruments are, by definition, securities or bank products, this raised questions about whether a broader assertion of authority by the CFTC would lead to jurisdictional disputes and increased legal uncertainty. If a hybrid instrument were legally determined to be a futures contract or an option, the exclusive jurisdiction clause could imply that only the CFTC could regulate the instrument, even if it is a security or a bank product. Conversely, if an instrument is not a futures contract or an option, an assertion of jurisdiction by the CFTC could lack a legal foundation.

B. Recommendations

[43] 17 C.F.R. pt. 34.

Hybrid instruments are, by definition, either securities or bank products, and are regulated as such. Nevertheless, there is not general agreement that all hybrid instruments should be entirely excluded from the CEA. Moreover, the Working Group does not recommend codification of the existing Hybrid Instruments Rule, because this would perpetuate the weaknesses of the rule without providing significantly greater legal certainty. As discussed below, however, a modification of the CEA's exclusive jurisdiction clause is necessary to ensure that questions do not arise as to the authority of the SEC and bank regulatory agencies with respect to hybrid instruments. To enhance legal certainty for hybrid instruments that reference non-exempt securities, the Working Group also recommends enactment of a provision to clarify that the Shad-Johnson Accord shall not be construed to apply to hybrid instruments that have been exempted from the CEA.

The CFTC believes that it may be possible to develop a new rule that provides greater legal certainty but does not exclude all hybrid instruments from the CEA. In recognition of the interests of the SEC and the bank regulatory agencies in this area, however, the CFTC will not propose any new rule relating to hybrid instruments without the concurrence of the other members of the Working Group. The other Working Group members will work with the CFTC on developing the rule and will give serious consideration to any proposals that it may make.

VII. Exclusive Jurisdiction

A. Background

The CEA gives the CFTC "exclusive jurisdiction" over commodity futures (and possibly commodity options), which means that a transaction that is regulated by the CFTC cannot be regulated by any other federal or state agency (except in certain limited circumstances where the CEA explicitly contemplates shared authority between the CFTC and another agency). This provision of the CEA has made jurisdictional disputes between the CFTC and other regulators particularly difficult, because a successful assertion of jurisdiction by the CFTC over a particular instrument or market divests other regulators of any authority. As noted above, the CFTC's comment letter on the SEC's "broker-dealer lite" proposal contended that the proposal extended beyond the jurisdiction of the SEC to regulate securities and ran afoul of the exclusive statutory authority of the CFTC. In addition, the exclusive jurisdiction clause has had the unintended consequence of impeding the SEC's enforcement program. In two recent cases, the SEC has been challenged on jurisdictional grounds, and asked to brief the court on why the exclusive jurisdiction clause does not preclude the SEC from bringing an enforcement action in a case involving instruments that would purportedly be subject to the CEA in the absence of the Treasury Amendment.[44]

B. Recommendations

The Working Group members agree that the exclusive jurisdiction clause of the CEA should be modified. Treasury, the Federal Reserve, and the SEC believe that the exclusive jurisdiction clause should apply only to transactions on designated contract markets, and that the clause should be clarified by providing that the CFTC's jurisdiction over such transactions is not exclusive in instances where the CEA or some other federal statute specifically grants another agency authority. At this time, the CFTC believes that it has not had sufficient opportunity to evaluate all of the possible ramifications of this proposal. The CFTC would, however, support an amendment to the CEA to provide that insofar as hybrid instruments may be subject to the CEA, the exclusive jurisdiction clause shall not be construed to limit the authority of the SEC and the bank regulatory agencies with respect to such instruments. Accordingly, the Working Group unanimously recommends that Congress adopt this clarification of the exclusive jurisdiction clause. In addition, the CFTC agrees that it will continue to work with the other Working Group agencies to develop its views on the merits of a broader modification of the exclusive jurisdiction clause.

VIII. Other Issues

A. Single stock futures

The Working Group members agree that the current prohibition on single stock futures can be repealed if issues about the integrity of the underlying securities market and regulatory arbitrage are resolved. Because a single stock future is a contract to purchase or sell a security

[44] See SEC v. Bankers Alliance Corp., Civ. No. 95-0428 (PLF) (D.D.C.); SEC v. Unique Financial Concepts, Inc., No. 99-4033 (11th Cir.).

and functions as a very close substitute for the underlying security, it may be appropriate to regulate these instruments as securities. On the other hand, because it is likely that such instruments would trade on organized futures exchanges, it may also be necessary to tailor legislation and regulation so as to take account of institutional differences between the futures markets and the securities markets.

From the perspective of the securities laws, the issues raised by trading of single stock futures include levels of margin, insider trading, sales practices, real-time trade reporting, and activities of floor brokers, as well as the exclusive jurisdiction of the CFTC over futures contract markets. From the perspective of the commodity futures laws, the issues raised by these instruments include clearing, segregation, large trader reporting, and direct surveillance.[45]

The SEC is the agency with expertise concerning regulation of securities and stock exchanges; the CFTC is the agency with expertise concerning the regulation of futures markets. Thus, the Working Group recommends that these agencies work together and with Congress to determine whether the trading of single stock futures should be permitted and if so, under what conditions.

The Working Group also notes that the futures exchanges' ability to offer a greater variety of equity-related products has been advanced by a recent court decision that interprets the SEC's authority to review proposed securities index futures contracts under the Shad-Johnson Accord[46] and by the lack of SEC objection to a recent single-sector futures contract on the Internet Stock Price Index.[47]

B. Regulatory and Tax Arbitrage

A criticism of OTC derivatives is that they can be used as a means to circumvent regulation. For example, certain institutional investors may be prohibited from investing in certain types of financial instruments but may be able to assume a nearly identical economic

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45 Treasury notes that questions as to the appropriate tax treatment of such instruments will also have to be addressed.

46 Board of Trade of the City of Chicago v. SEC, 1999 U.S. App. LEXIS 18469 (7th Cir. 1999).

47 See Letter from Robert L.D. Colby, Deputy Director, Division of Market Regulation, SEC, to Steven Manaster, Director, Division of Economic Analysis, CFTC (Mar. 12, 1999).

position by entering into a derivatives transaction. The Working Group is aware that the derivatives industry has been quite creative in tailoring particular products to achieve certain regulatory results that were not originally intended. As difficult as the task may be, the Working Group nonetheless believes that in most instances such issues should be addressed by amending underlying statutes and regulations, not by attempting to use the CEA to solve these issues.

Derivatives can also be used to achieve certain tax results that differ from those resulting from investments in the underlying commodity. For example, derivatives have been used in ways that arguably change the character, source, or timing of income. Treasury is particularly concerned about these issues and has been addressing them through changes in regulation and by proposing legislative changes. For example, the assumption of a derivatives position that eliminates substantially all of the economic risk of an investment asset held by the taxpayer is now viewed as a constructive sale and is thus a taxable event. Again, as in the area of regulation, the creativity of the derivatives industry in this area has given rise to many issues of concern to Treasury and the Internal Revenue Service. Tax creativity in the structuring of transactions, however, is not new, and the Working Group believes that these issues need to be addressed under the Internal Revenue Code and regulations. The CEA should not be used to solve tax issues.

C. Netting

The Working Group reiterates its support for the improvements in the close-out netting regime for derivatives and other financial instruments under the Bankruptcy Code and bank insolvency law recommended in the April 1999 report, Hedge funds, Leverage, and the Lessons of Long-Term Capital Management. As discussed in that report, there are improvements currently under consideration by Congress that would reduce systemic risk and protect the markets. Specifically, these proposals would improve the netting regime under the Bankruptcy Code by expanding and clarifying definitions of the financial contracts eligible for netting and by explicitly allowing eligible counterparties to net across different types of contracts, such as swaps, security contracts, repurchase agreements, and forward contracts. They would also clarify bankruptcy procedures for an entity organized in a jurisdiction outside of the United States that has its principal business in the U.S. and help to ensure that in an ancillary proceeding in the U.S.

there will not be an issuance of a judicial stay preventing an eligible counterparty from exercising contractual termination, netting, and liquidation rights for certain financial contracts recognized under U.S. law. Finally, the netting provisions would clarify the netting regime for certain financial contracts in the case of a bank failure. The Working Group believes these proposals should be enacted into law.

D. Derivatives dealers

Derivatives dealers are entities whose business consists primarily of entering into derivatives contracts with end users and other dealers. Derivatives dealers may also use OTC derivative instruments to hedge their own financial risks, including risks incurred to obtain desirable financing terms, and to speculate on market movements. Most OTC derivatives dealers in the U.S. are banks or affiliates of banks, or affiliates of broker-dealers or FCMs. Banks and their affiliates are subject to consolidated supervision by banking regulators, but the affiliates of broker-dealers and FCMs are generally unregulated, although the SEC and the CFTC have limited authority to obtain information about the activities of such affiliates, and the SEC has instituted a special regulatory scheme for derivatives dealers that conduct a limited securities business. A small number of U.S. derivatives dealers are affiliated with entities that are not subject to banking or securities regulation, such as insurance companies, finance companies, and energy companies.

With respect to OTC derivatives dealers, private counterparty discipline currently is the primary mechanism relied upon for achieving the public policy objective of reducing systemic risk. Government regulation should serve to supplement, rather than substitute for, private market discipline. In general, private counterparty credit risk management has been employed effectively by both regulated and unregulated dealers of OTC derivatives, and the tools required by federal regulators already exist. In its report on <u>Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management</u>, however, the Working Group concluded that limitations on SEC and CFTC access to information about the activities of the unregulated affiliates of broker-dealers and FCMs constituted a gap in the system of financial market oversight that should be filled by providing the relevant agencies with enhanced authority to obtain risk assessment information. Because of the importance of these affiliates in the OTC derivatives market, the Working Group reiterates this recommendation.[48]

By contrast, the activities of derivatives dealers that are not affiliated with banks, broker-dealers, or FCMs constitute a small share of the overall market, although the extent of their participation in certain markets, such as the market for energy derivatives, is quite significant.[49] In light of their small market share and the apparent effectiveness of private counterparty discipline in constraining the risk-taking of such derivatives dealers, the Working Group is not recommending legislative action with respect to such derivatives dealers at this time, but believes that continued monitoring of their development is appropriate.

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48 But see note 36 above.

49 Unaffiliated derivatives dealers are active primarily the markets for OTC derivatives on tangible commodities, which account for only a fraction of a percent of derivatives activity. See note 4 above. Moreover, in 1998, the top 25 derivatives dealers worldwide were banks, securities firms, or affiliates thereof. Swaps Monitor, vol. 12, no. 19 (Aug. 2, 1999).