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November 2, 2000

## COMMENT

### Regulatory Reinvention

Ladies and Gentlemen:

I am writing on behalf of the International Swaps and Derivatives Association, Inc. ("ISDA"). ISDA submitted comments dated August 7 on the Regulatory Reinvention initiative (the "Initiative") of the Commodity Futures Trading Commission (the "Commission"). This letter contains additional comments on the proposals entitled (1) "Exemption for Bilateral Transactions" (the "Bilateral Proposal") and (2) "A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations" (the "Multilateral Proposal"), proposed 17 CFR Parts 35 and 36, respectively, as published in the Federal Register for June 22, 2000 (65 Fed. Reg. No. 121 at 38986 et seq.).

At the outset, ISDA affirms its support for the Initiative. Although ISDA believes that its prior comments and the additional comments it is now offering are very important, this letter does not indicate diminished enthusiasm for the Initiative in general.

Since it submitted its August 7 comment letter, ISDA has learned of a possible misunderstanding underlying the first exclusion (proposed Part 36.1(b)(i)) from the definition of multilateral transaction execution facility ("MTEF") contained in the Initiative. As written, the exclusion does not permit creation of a binding agreement on an excluded facility. ISDA now believes that this is intended only to bar use of the exclusion by exchange-like facilities where, as a matter of rule, transactions are binding. The language of the exclusion would, however, also make the exclusion unavailable to facilities where the binding nature of the agreement is itself a matter of the bilateral dealing between the two parties, and not the

result of any rule of the facility.

ISDA believes that this distinction between transactions binding by rule and those binding by the mutual, bilateral agreement of the parties as a matter of contract law is key--if the exclusions from the definition of MTEF are intended to reflect aspects of existing off-exchange dealing. By contrast, the distinction made in the existing draft exclusion between systems offering transactions subject to "subsequent acceptance" and other systems is not particularly useful. Assuming systems now exist where participants must go off-line, or otherwise delay, to agree (subsequent acceptance), technological progress will inevitably diminish these systems' appeal, and the usefulness of the exclusion as well.

ISDA would like to offer the following as a replacement for the existing first exclusion:

(i) A facility whose participants individually negotiate (or have individually negotiated) with counterparties material terms applicable to transactions between them based upon any of the items listed in or determined pursuant to Part 36.2(b), including transactions conducted on the facility (which transactions are not required to be binding by any rule of the facility or by any collective agreement among multiple facility participants).

This revised exclusion would not be available to facilities where by facility rule or collective agreement transactions are deemed binding. It would be available, however, to facilities where participants in pairs are free to enter into binding terms or not, as they see fit. These must be facilities whose participants negotiate material terms (though not all "the" material terms, as implied in the existing draft).

It is important to note that any system falling within this exclusion would not benefit from the "legal certainty" aspects of the Initiative unless the system were restricted to transactions within proposed Part 35, effectively limiting itself to "eligible participants." In all cases, the Commission's anti-fraud and anti-manipulation jurisdiction would be retained.

ISDA believes that this revised exclusion will fairly treat historically bilateral business practices and will, in the words of the Part 36 proposing release, "promote innovation, maintain U.S. competitiveness, and at

the same time reduce systemic risk and protect customers."\*

ISDA has reviewed the second exclusion from the definition of MTEF (proposed Part 36.1(ii)) in light of the present state of electronic systems development and the likely direction that such development will take. ISDA believes that a faulty assumption may underlie this exclusion. The assumption is that a system will work either by effecting bilateral communications alone or by use of a multiple order, pre-determined, trade-matching algorithm. The assumption does not contemplate what is more likely-- development of systems that rely on the parties' bilateral negotiations, but that also perform useful, supporting sorting, matching and finding functions that make the process more efficient. In other words, account should be taken of systems that use predetermined, computerized matching and sorting "skills" in ways that do not replicate exchange trading, but that do support purely bilateral arrangements. In this context, please consider the following, modified version of the second exclusion:

(2) Any electronic communication system used in negotiating, agreeing to or producing transactions that:

(a) Would not exist but for the content of bilateral communications exchanged between the parties (through the system or otherwise), concerning material terms\*\* other than price and quantity alone; and

(b) Do not result solely from the interaction of multiple bids and multiple offers within a predetermined, non-discretionary, automated trade matching and execution algorithm.

This modified exclusion recognizes that genuinely bilaterally negotiated transactions may enjoy the benefits of computerized support. Interaction between established bilateral transactional methodology and new technology will be necessary if bilateral methodology is to remain competitive in this new technological age. This exclusion, as redrafted, insures that this positive interaction will not lead to any blurring of the regulatory status of bilateral transactions. The redrafted exclusion also

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\* Proposed Part 35.2(d)(4) should be adapted to conform to the revised exclusion and to reference all the Part 36.1(b) exclusions.

\*\* "Material terms" would constitute credit or other economic terms.

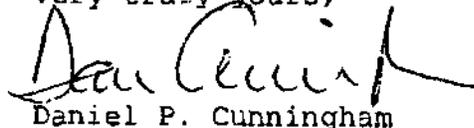
preserves the importance of "execution" as an MTEF criterion by inserting the word in the description of a "matching" algorithm.

Turning now to the Bilateral Proposal, proposed Part 35, ISDA wishes to underscore generally the changes it suggested in its August 7 letter. In particular, ISDA notes the importance of making it clear that proposed Part 35 encompasses both principal-to-principal and agency transactions, bounded by the requirement that only "eligible participants" be involved. If agency transactions involving solely eligible contract participants are not generally covered by Part 35, then at a minimum, agency transactions involving an entity acting on behalf of its affiliate should clearly be within the proposed exemption. This would be consistent with past Commission positions in analogous circumstances, see Letter of Andrea M. Corcoran, Director, Division of Trading and Markets, Commodity Futures Trading Commission to P. McBride Johnson, May 9, 1994, and consistent with the goals of the Initiative.

As you know, most of ISDA's membership is engaged in bilateral transacting of derivatives. Bilateral transacting, "OTC" transacting, has been a major component in the global expansion of derivatives, and a major source of innovation and strength in finance in the United States. Bilateral transacting will flourish best in the United States in this time of rapid change only if it is regulatory status is clear in the Commission's Initiative. ISDA hopes that its comments, in this letter and its letter of August 7, will help the Commission achieve this goal.

We would be delighted to discuss the foregoing with you. Please do not hesitate to call me or Don Moorehead at 202/457-5212.

Very truly yours,



Daniel P. Cunningham

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