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August 21, 2000

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Ms. Jean Webb
Secretary
Commodity Futures Trading Commission
3 Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

Dear Ms. Webb:

Re: 65 Fed.Reg. 38986; 65 Fed. Reg. 39008; 65 Fed. Reg. 39027; and 65 Fed. Reg 39033 (June 22, 2000)

We appreciate this opportunity to comment on the series of Federal Register releases, identified above, containing proposals by the Commodity Futures Trading Commission ("CFTC") to improve the regulation of commodity futures and options markets. These proposals are related to the CFTC staff report, issued on February 22, 2000, entitled "A New Regulatory Framework." The staff report was issued in response to a request by the Chairmen of the Senate and House Agriculture Committees, who asked the CFTC to "use the exemptive authority granted it by the Commodity Exchange Act to lessen the regulatory burdens on United States' futures markets so that they may compete more effectively." Going beyond that request, the proposals also "expand and clarify the operation of the current swaps exemption."

We support the CFTC's efforts to reduce or eliminate unnecessary regulatory burdens on futures contracts. The steps to replace the current one-size-fits-all futures regulation with broad, flexible core principles; to establish three tiers of regulation tailored to the nature of the products and the sophistication of the participants; and to move away from micromanagement and toward a supervisory approach demonstrate a sincere desire to modernize the regulation of futures trading and to remove obstacles to the competitiveness of US futures exchanges. The Commission's approach is a welcome change from recent years, and we look forward to working with the Commission as their efforts progress.

As noted above, the CFTC has also proposed changes to the swaps exemption. The CFTC has indicated that these changes are designed to expand on existing exemptions, and thereby provide greater "legal certainty" to participants in swap activity. In our comments we focus on that aspect of the CFTC proposal.

Swaps differ substantially from futures contracts. Futures are regulated by the CFTC under the Commodity Exchange Act (CEA), which was written to regulate standardized, exchange-traded products. But that statute is inappropriate for the regulation of swaps. Swap transactions simply do not fit within the regulatory framework administered by the CFTC. The CEA is so inappropriate for the regulation of swap activity that if swaps were regulated under the Act, its exchange-trading requirement and Shad-Johnson provisions would instantly call into question the enforceability of thousands of swap transactions and undermine billions of dollars' worth of value on the books of banks, brokers, and corporations. This is only a symptom of the inappropriateness of CFTC regulation of these activities; even if questions about enforceability were favorably resolved, we do not know of any swap contract that should be regulated by the CFTC. Swaps are not futures.

For that reason, we have enjoyed working with the CFTC for more than a decade to establish a policy framework that reflects the CFTC's own conclusion, first expressed in the 1989 Swaps Policy Statement, that swaps are not appropriately regulated as futures. In part, that has entailed statutory reform, notably the passage of the 1992 Futures Trading Practices Act, and similar efforts in this Congress. Because the ambiguities in the CEA itself are the source of questions about CFTC regulation of swaps, and the enforceability of certain contracts, statutory reform is an appropriate way to solve the problems. The CFTC has limited ability to resolve them on its own. A statutory interpretation from the CFTC indicating that swaps are not futures would have the necessary effect, but attempts to resolve these statutory questions by amending regulations are unlikely to succeed in countering the impact of the statute, and may even be counterproductive.

In its attempt to resolve these questions by issuing the proposed rules, the CFTC relies mainly on the exemptive authority given the agency by Congress in the 1992 Futures Trading Practices Act. But the power to exempt may imply the power to regulate. In undertaking regulatory reform, the Commission does not have the luxury of designing a new regulatory structure from the ground up; any deregulation must conform to the Commodity Exchange Act and its Shad-Johnson provisions. Given the inflexibility of this inherited framework, and the potential implication of partial exemptions from the CEA, any attempt by the Commission to exercise its exemptive authority must be approached with great caution.

Of particular concern is the risk that exemptions contained in the Proposals could ultimately lead to regulation or even unenforceability of certain contracts, even if the Commission's intention was to do exactly the opposite. In this comment letter we will describe two specific ways in which the proposed exercise of exemptive authority might work against the Commission's efforts to increase legal certainty. We believe, therefore, that for the CFTC to attain its objectives it will be necessary to modify its Proposal and we will propose changes to the Proposal that might help to reduce or eliminate the uncertainties.

The Commission's Proposal illustrates these risks. The Proposal presents a visionary approach to regulation of futures markets that is likely to be more appropriate for the developments of the 21st century. Unfortunately, even as it does so, the Commission is constrained by an Act geared for the 19th century.

The Proposal seems to indicate that the Commission is moving towards an opt-in regulatory structure, which would allow market participants maximum flexibility to choose their organizational and operating structure. For instance, the idea embodied in the Proposal that an entity could choose CFTC regulation (for example, by choosing to register as a clearing organization), or choose to operate outside such regulation, creates a new opportunity for businesses to choose the regulatory framework most suited to the needs of their customers. It draws on similar elements in the regulatory framework for depository institutions and other lenders, which permits the same type of choices.

However, the Proposal ultimately stops short of this approach, no doubt because of a recognition that the Act itself prevents this bold endeavor. Instead, the Commission is forced to take half-steps in this direction, and they actually lead away from the goal of legal certainty. Two specific examples illustrate this point:

Multilateral Transaction Execution Facilities (MTEFs). Part 36 of the Proposal contains a "self-effectuating" rule that would apply to any MTEF that meets the conditions specified in the rule. The MTEF would be exempted from all portions of the CEA except those provisions prohibiting fraud and manipulation, and any rule regarding dissemination of pricing and trading information that the Commission may enact in the future. The Proposal would allow an MTEF that operates under this structure to choose to opt-in to another CFTC regulatory alternative by seeking designation as a CFTC-regulated market, provided it meets the terms and conditions for such a market.

We applaud the CFTC for proposing that entities be allowed to voluntarily "opt-in" to CFTC regulation. This is a concept that, were it allowed by the Act, would serve American financial markets well. However, currently the CEA allows the Commission authority to regulate only futures, leverage, and certain options transactions. Any attempt to regulate products that do not fit within these categories is outside the CFTC's statutory authority, and therein lies the difficulty with the proposed Part 36.

Because 4(c) of the Act is quite explicit in allowing the CFTC to exempt "any agreement, contract or transaction. . . otherwise subject to (the exchange trading requirement)," and because the exchange trading requirement is limited to "a contract for the purchase or sale of a commodity for future delivery," it is clear that the CFTC may only exempt from the Act futures contracts. Were the Proposal limited in its scope to futures contracts, there would be little concern for the Proposal's effect on legal certainty. However, the Proposal, and particularly Part 36, apparently seeks to exempt transactions which are not futures contracts.

Part 36 refers specifically to the availability of Exempt MTEFs as a platform for transactions in "total return," "credit," and "credit spread" swaps. An Exempt MTEF is to be subject to the anti-fraud and anti-manipulation provisions of the Act, as well as to whatever future rule the Commission may enact governing information dissemination. Therefore, a proposed "exemption" from the CEA has the effect of extending the Commission's authority to facilities that may trade products, such as swaps, which are not the Commission's to regulate under the terms of the Act itself. A self-effectuating "exemption" in this instance unintentionally becomes the reverse, an assertion of CFTC jurisdiction over non-futures products.

The singling out of particular types of swaps for "exemption" has disturbing implications. The named swaps are commonly based upon the price of corporate equities or, in the case of credit swaps, corporate debt, which is represented by a non-exempt security. The Commission is given authority under 4(c) to exempt futures contracts. But if these particular swaps are futures, they cannot be exempted because they would run afoul of the Shad-Johnson Accord, which bans futures on non-exempt securities prices (except for indexes which have cleared a lengthy regulatory approval process). The Part 36 exemption will be of no use because it specifically does not exempt such transactions from the Shad-Johnson Accord. So if the Commission has authority to exempt these transactions (which would only be the case if they are futures), it cannot do so (because the Shad-Johnson Accord prohibits such futures). Rather than tackle this type of no-win, Catch-22 for legal uncertainty, it would be better if the Commission clearly focused its Proposal on futures contracts, and omitted all references to swap contracts. For the same reason, we commend the CFTC for taking this approach in its Proposed revised Part 35.

Recognized Clearing Organizations (RCOs). The treatment of RCO's under the Proposal gives rise to similar concerns. Part 39 would authorize RCOs to clear transactions otherwise exempted from the CEA by Part 35 (bilateral transactions) and Part 36 (MTEFs). Part 39 also says a clearing organization that has been recognized by the Commission shall be deemed to be a "contract market". It is not clear that the two are consistent with the Commission's exemptive authority, and again might lead to increased uncertainty.

The CFTC has jurisdiction over clearing organizations only to the extent that they are contract markets. By law, those contract markets may only list futures and options thereon. The Proposal would allow clearing organizations to register with the Commission as contract markets for the clearing of exempted transactions.

It is difficult to avoid concluding, therefore, that those exempt transactions are futures. How else could they be cleared on contract markets? That poses a threat to the enforceability of certain transactions.

We have a third, serious concern. In drafting various parts of its proposal, the Commission uses terms that raise questions about the scope of the CFTC's jurisdiction

and therefore, about the enforceability of certain contracts. By referring repeatedly to "derivatives transactions" and "contracts, agreements and transactions" instead of to "contracts for the purchase and sale of a commodity for future delivery," the Proposals foster ambiguity and uncertainty about their scope and their intended effect.

We believe that this problem could be avoided altogether by revising the rule so that it identifies the affected transactions by using the terms in the statute rather than creating new terms. This would greatly reduce the chances of doing damage to the enforceability of certain transactions.

The CEA gives the CFTC authority over contract markets, boards of trade, contracts for the purchase or sale of a commodity for future delivery, options thereon and commodity options. These are the activities that the CFTC regulates and these are the activities that the agency has the authority to deregulate. The final rules should refer only to these activities, and by name.

Taking this approach in the final rules, using terms in the CEA rather than inventing new terms, provides all of the benefits of exemptive relief, both for futures and for swap activity, without raising dangerous questions about the enforceability of other transactions. Exempting futures from provisions of the Act would protect off-exchange transactions just as effectively as exempting the off-exchange transactions themselves, since any court that makes the mistaken determination that a contract is a futures contract would then seek to determine whether that so-called futures contract had been exempted from the exchange trading requirement and the other relevant provisions of the Act. Therefore, the benefits of the exemptive relief in the final rule would be available at the very moment that relief is needed, that is, the moment that a transaction is deemed to be a futures contract.

We look forward to providing the CFTC with detailed suggestions about how to carry out this recommendation.

We thank you again for the opportunity to comment on the proposed rules. We support the CFTC's efforts to reduce or eliminate unnecessary regulatory burdens on futures contracts, and we look forward to working with the CFTC to achieve greater legal certainty for swaps.

Sincerely,