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August 7, 2000

COMMENT

Commodity Futures Trading Commission  
Three Lafayette Centre  
1125 21<sup>st</sup> Street, N.W.  
Washington, D.C. 20581

Attn: Office of the Secretariat

Re: Regulatory Reinvention

Ladies and Gentlemen:

The rule proposals of the Commodity Futures Trading Commission (the "CFTC") have a great deal of merit. The proposed exemption for bilateral contracts has particular merit in that it is an effort to provide more certainty regarding the enforceability of a wide range of ordinary commercial contracts (referred to herein as "contract enforcement certainty") entered into by both commercial counterparties and financial intermediaries that provide risk management services. We also applaud the CFTC's proposal to give rule status to the swaps safe harbor. However, the CFTC proposes that a large and growing class of over-the-counter market participants --- namely Internet-based business-to-business auction sites with multiple participants --- will be entitled to contract enforcement certainty only if they submit themselves to CFTC regulation as boards of trade (either RFEs or DTFs). In effect, the CFTC is proposing to become the federal agency that regulates multiple participant business-to-business auction sites on the Internet. See "Practical Effects of The Rule Proposals, if Adopted," below. The CFTC proposes, in effect, to expand the scope of its regulatory domain to heretofore unregulated over-the-counter commercial markets. We believe that such an expansion is inappropriate.

As explained in this letter, the most significant and far reaching problem with the rule proposals is that multilateral transaction execution facilities --- regardless of the nature of their participants or the nature of the economic activity being undertaken on those facilities --- must agree to become regulated by the CFTC in order to obtain contract enforcement certainty. We believe this is inappropriate for the reasons set forth in this letter and that the proposal relating to bilateral contracts needs to be revised so that the exemption is available for use in all over-the-counter markets in which participation is limited to qualified commercial counterparties and financial intermediaries who are using these markets for bona fide business purposes --- markets

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in which speculators and members of the public do not participate. This approach is quite consistent with the existing regulatory scheme, whereby speculators may participate in commodity futures and options trading only on regulated boards of trade

As you know, enormous growth is projected for business-to-business trading on the Internet. The Internet promises to bring economic benefits through market efficiencies, unless innovative uses of the Internet are stifled by governmental interference. We believe that the proposed rules, if adopted as proposed, could result in a huge expansion of the CFTC's regulatory domain to Internet-based multiple participant trading sites. The CFTC's authority will extend to significant activities in the over-the-counter markets that are unregulated under current law and that were never intended to be regulated under the Commodity Exchange Act (the "CEA"). This is because, if the proposals are adopted, the CFTC will regulate Internet sites even if the vast majority of the economic activities on those sites is outside the CFTC's jurisdiction. We do not believe this expansion of the CFTC's domain to the Internet should be effected without Congressional action.

And the biggest problem with the CFTC proposals is that (at least in the one respect discussed in this letter) they have lost site of the CFTC's regulatory purpose. Rather than distinguishing what is and what is not to be regulated based on the substance of the economic activity being undertaken, the CFTC has in effect chosen to regulate or not to regulate based on the mechanics of contracting, as explained below under "The Proposed Exemption for Bilateral Contracts."

Background

Our law firm represents a number of entities that have organized or invested in, or are in the process of organizing or investing in, Internet-based auction-style trading sites that are aimed at using the Internet to introduce efficiencies in business-to-business transactions. These sites generally permit or will permit participation only by commercial counterparties and, in some cases, financial intermediaries that provide risk management services. These sites are not and will not be used by speculators and will only be used by substantial business entities. The purpose of these sites is purely commercial in nature, and they promise to provide a more efficient means for participants to purchase or sell property or services or to manage commercial risks. We believe that the CFTC has not demonstrated a need to regulate these sites as boards of trade, even with the less heavy handed regulatory scheme proposed for DTFs.

The first thing a student learns about the CEA and its predecessor statutes is that they were and are aimed at a "form of economic activity." Johnson and Hazen, *1 Commodities Regulation*, §1.02 (3<sup>rd</sup> ed. 1999). In distinguishing between futures contracts (which are subject to regulation under the CEA) and forward contracts (which are not), courts have viewed each transaction as a whole "with a critical eye toward its purpose." When the courts have focused on the form of economic activity, they have not used the word "form" as the opposite of substance (as in "form over substance"). Fundamentally the core notion of the CEA and its predecessor statutes was and is that, although price speculation is inherently evil (in that it is akin to

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gambling), if the government will permit speculators to participate in futures markets those markets will be more efficient and therefore will send more "accurate" price signals. So when it enacted the Grain Futures Act in the 1920's Congress decided that futures markets in which speculators participate could exist as long as they were regulated. This concept was carried over to the CEA.

Cases distinguishing forward contracts from illegal, off-exchange futures contracts have come up with a laundry list of features that are characteristic of futures contracts. Futures contracts are more likely than forward contracts to be exchange-traded and to have standardized terms, but it is still the fundamental economic activity that the courts have focused on in deciding what is within and what is outside of the regulatory scheme of the CEA and its predecessor statutes. The CFTC has had great difficulty in dealing with swaps. In the swaps safe harbor, the CFTC stated that swaps are not appropriately regulated as futures contracts if, among other things, they are not standardized. In the swaps exemption, the CFTC conditioned the exemption on the requirement that they not be traded on a multilateral transaction execution facility. We believe that it would be just as ludicrous to regulate swaps solely because they are traded on multilateral transaction facilities than it would be to regulate them solely because they are standardized. Moreover, the economics of a swap can be duplicated precisely with a pair of trade options. Under current rules trade options are free from regulation if they are offered to commercial counterparties that are entering into the transactions in connection with their businesses. The nature of the counterparties and the reasons for the transaction are far, far more important than any other factor in characterizing swaps, options or other contracts as covered or not covered by the CFTC's jurisdiction.

But in its rulemaking proposals the CFTC proposes in effect to regulate or not regulate depending on the *mechanics* of contracting, i.e. the steps taken by the parties to enter into the contract. In proposing to make such a distinction, the CFTC has lost sight of the core notion of the commodities laws. The proposals in effect extend the CFTC's regulatory supervision to multiple participant multilateral transaction execution facilities ("MTEFs") simply because the contracts are entered into on the Internet, and regardless of whether the parties are speculators or commercial counterparties that enter into transactions for bona fide business purposes.

For many years we have been involved in numerous transactions in which our clients have had to face the uncertainties caused by case law distinguishing futures contracts from forward contracts. This case law presents an enforceability risk even for certain contracts that are entered into solely for the purpose of making and taking delivery of a commodity. For example, in the *Transnor (Bermuda) Limited v. BP North American Petroleum*, 738 F.Supp. 1472 (S.D. N.Y. 1990), which was settled before an appeal could be heard, parties that entered into contracts to purchase shiploads of crude oil in the Brent North Sea crude oil market were unable to enforce those contracts because a significant number of *other participants* in the market routinely cash settled contracts traded in the same market through "book out" transactions. Thus, for reasons unrelated to the actions or intentions of the purchaser or seller, a seller was able to escape its obligations under a contract that by its terms required delivery and

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that had been entered into by the purchaser specifically for the purpose of obtaining supplies of crude oil.

The CFTC attempted to counter the destabilizing affects of the *Transnor* case by publishing its Statutory Interpretation Concerning Forward Contracts 55 Fed. Reg. 39, 188 (Sept. 25, 1980), reprinted in CCH Comm.Fut.L.Rep. [1990-92 Transfer Binder] ¶24,925. The CFTC took the position that the Brent North Sea Crude Oil market was not an illegal futures market. However, in its statutory interpretation the CFTC did not discuss the court's findings regarding "book out" transactions. We understand that subsequently, in connection with no action letters involving electronic trading facilities, the CFTC staff has issued various no action letters in which it has required recipients to report back to the CFTC staff if more than 25% or 30% of contracts traded do not result in actual physical delivery. So it appears that the CFTC staff believes that the "book out" issue still has validity from an enforcement standpoint, except in the case of transactions covered by the Exemption for Certain Energy Contracts, which sanctions unlimited book outs through subsequently negotiated contracts. Exemption for Certain Contracts Involving Energy Products, 58 Fed. Reg. 21,286, reprinted in CCH Comm.Fut.L.Rep. [1992-94 Transfer Binder] ¶25,633.

The CFTC's proposed exemption for bilateral contracts has great promise in that it could be used as a vehicle to extend to commercial counterparties the relief from the "book out" concern that was granted for a relatively narrow class of commodities in the energy contract exemption. The CFTC should provide this contract enforcement certainty for all markets that are used solely by substantial commercial counterparties for nonspeculative purposes related to their businesses. We believe that it is inappropriate for the CFTC to deny that relief to multilateral transaction execution facilities unless they voluntarily submit themselves to CFTC regulation. And, as explained below, we believe it is inappropriate for any regulatory relief to turn on the mechanics used to enter into contracts.

#### The Proposed Exemption for Bilateral Contracts

The CFTC's rule proposal granting relief for "bilateral contracts" relies heavily on the proposed definition of Multilateral Transaction Execution Facility. The upshot of the CFTC's definition is, in the Internet context, as follows:

(1) an MTEF is a multiple participant Internet site that matches participants for trades, and when the participants are matched the contract is completed and the deal is done (a "point and click contract");

(2) a non-MTEF is either a site on which a single party offers to enter into trades with multiple counterparties (a "single party site") or a multiple participant Internet site that says to its participants that, once they are matched on the site, the participants must go off-line to complete the trade by exchanging paper confirmations or otherwise engaging in one-to-one communications that result in a contract.

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In each case, a contract is made and the fundamental economic activity is identical, but in the latter case an additional step is required. In effect, the CFTC rule proposals give regulatory relief by providing contract enforcement certainty to (a) all contracts entered into by eligible parties, other than point-and-click contracts, and (b) point-and-click contracts that are entered into by eligible parties on any Internet site that chooses to be regulated as a board of trade (a DTF or a RFE) or on any single party site.

We believe there is no valid public policy reason for the CFTC's proposed line of demarcation between MTEFs on the one hand and single party sites or multiple participant sites that require participants to go off-line on the other. The multilateral transaction execution facility concept is, to be sure, part of the swaps exemption, and cases distinguishing forwards from futures have listed exchange-style trading (among a laundry list of other features) as *one* of the characteristics that distinguishes forwards from futures. But the MTEF-non-MTEF distinction should not be the principal feature on which the regulatory scheme turns. Indeed, the principal feature on which the regulatory scheme has heretofore turned relates to *price speculation and the presence of speculators in the markets*, not the mechanics of entering into contracts. The CFTC should not regulate, and should give contract enforcement certainty to, multiple participant Internet auction sites whose participants are solely commercial parties and that require their participants to represent, as a condition to using the site, that they are using the site solely for bona fide commercial reasons (either for physical delivery or risk management purposes).

Getting Back to the Basic Regulatory Purpose

The CFTC's exemption for bilateral transactions should extend to all markets that do not permit speculators to participate and that are used solely for bona fide commercial reasons (either for physical delivery or risk management purposes). The existing dividing line between the regulated markets and the over-the-counter market would be preserved. This is consistent with the fundamental purposes of the CEA.

And in the Internet context it would be very unsound to grant or deny regulatory relief or to choose to regulate or not to regulate depending on whether the contracts are "point and click" contracts or contracts entered into by means of paper confirmations.

To be sure, the multilateral transaction execution facility concept exists currently in the swaps exemption, but that exemption was passed prior to the Internet age. The Internet promises to be a principal means by which commerce is conducted in the United States. For sound commercial reasons, Internet auction sites that permit parties to enter into physical delivery contracts (including those that book out prior transactions) and risk management contracts (such as swaps) will perform valuable roles in the future of our economy. Their development should not be stifled by the CFTC's regulatory scheme.

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#### Practical Effects of the Rule Proposals, if Adopted

If the rules are adopted as proposed, every multiple participant business-to-business Internet site operator will have choose whether to operate its site as a regulated MTEF or as a non-regulated non-MTEF. If it chooses to remain unregulated, in the case of physical delivery contracts it will have to make sure that (except in cases covered by the energy contracts exemption) too many book out transactions will not occur. With respect to other contracts, such as swaps, it will need to put in place trading rules that require matched participants to go off-line to complete the trades. Or it may choose to document its swaps as trade options. So each multiple participant Internet site operator will have to decide whether to undertake the expenses associated with DTF status and weigh those expenses against the burdens associated with adopting the procedures set forth above or other procedures designed to avoid CFTC regulation.

If the rules are adopted as proposed, entities that choose to be CFTC-regulated MTEFs will no doubt use their regulated status as a selling point in an effort to gain a competitive advantage over multiple participant sites that choose not to be regulated, perhaps exaggerating the risk that a unregulated competitor's contracts will be unenforceable. If this selling point becomes a significant competitive advantage, many if not most multiple participant Internet auction sites will be forced by economic necessity to submit themselves to CFTC jurisdiction.

So that is why we are concerned that the rules are designed to permit the CFTC to become the principal federal regulatory agency that regulates Internet-based business-to-business trading sites. We believe that this is not a mission that Congress intended for the CFTC to undertake. If the rules are adopted as proposed and the Internet develops as promised into a primary means for doing business in the United States, for the first time markets that do not involve speculators and that are confined to substantial businesses who use the sites solely for commercial purposes will be engulfed within the CFTC's regulatory domain.

#### An Approach that is Consistent with the CFTC's Mandate

By far the best approach, and the correct approach insofar as the fundamental purposes of the CEA are concerned, is for the proposed rules to be modified so that the exemption for bilateral transactions is available to all transaction execution facilities whose participants consist solely of commercial counterparties that are using the facilities to purchase or sell products or services in connection with their businesses or to obtain risk management services from financial intermediaries. We strongly urge the CFTC to revise its rule proposals to adopt such an approach.

#### Extension of Comment Period

The CFTC's proposals are so far reaching that we believe that an extension of the comment period is appropriate. We believe that the business community, and particularly the Internet business community, generally is unaware of the far reaching implications of the

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proposals. The hearings on June 27 and 28 were dominated by regulated boards of trade, financial intermediaries and legal professionals, and there appeared to be no representation from sponsors of Internet sites or other commercial counterparties. As time goes on there will be more awareness of the implications of the proposals. With additional time for comments on the proposals the CFTC should receive more comments, which should improve the rulemaking process.

Very truly yours,

VINSON & ELKINS L.L.P.

By Robert S. Baird  
Robert S. Baird