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COMMENT

September 6, 2000

OFFICE OF THE SECRETARY

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RECEIVED
OFFICE

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, DC 20581

Re: Proposed Parts 35 and 36 of the Commission's Rules: Exemption for Bilateral Transactions and Regulatory Reinvention

Dear Ms. Webb:

We are submitting this comment letter on behalf of our client, The EBS Partnership ("EBS"), in response to the Commodity Futures Trading Commission's (the "Commission") releases published June 22, 2000, proposing a revised Part 35 of the Commission's rules, titled *Exemption for Bilateral Transactions*, and a new Part 36 of the Commission's Rules, titled *A New Framework for Multilateral Transaction Execution Facilities* (the "Proposed Rules").

EBS is a U.K. limited partnership¹ whose subsidiaries operate, among other systems, an electronic, screen-based trading system for anonymous spot foreign exchange transactions in major currency pairs (the "FX System"). The FX System is available to approximately 800 participants, consisting exclusively of banks and institutional foreign exchange market participants, dealing as principals, in 26 countries, including the United States.

¹ EBS's 15 limited partners include U.K. affiliates of major international banking and brokerage groups, including affiliates of U.S. banks and broker-dealers.

The FX System processes 30,000 transactions per day, and daily volume is approximately U.S. \$90 billion, more than 50% of the market for brokered interbank transactions.

In addition, EBS's subsidiaries have operated similar electronic, screen-based trading systems for forward rate agreements between similar dealer and institutional market participants and intend to expand such systems to permit the trading of swaps and other over-the-counter ("OTC") derivatives involving financial commodities. These systems electronically facilitate the bilateral execution of transactions on a principal-to-principal basis in a manner analogous to traditional voice brokerage.

EBS appreciates the opportunity to comment on the Proposed Rules. EBS strongly supports the Commission's efforts to enhance the legal certainty of OTC derivatives involving financial and other commodities and the ability of U.S. market participants to enter into such transactions on electronic trading and dealing facilities. The Proposed Rules significantly advance this goal by generally expanding the scope of the Commission's existing Part 35 Swap Exemption (the "Current Swap Exemption") and, for the first time, providing legal certainty for transactions executed on multilateral transaction execution facilities ("MTEFs"). The latter change, in particular, would allow EBS and other system providers to make available to U.S. market participants the types of electronic trading systems that have already begun to be developed in other jurisdictions.

Nevertheless, EBS believes that in one significant respect—the treatment of electronic systems that feature credit screening—the Proposed Rules might unnecessarily narrow the scope of the Commission's Current Swap Exemption and create an additional source of legal uncertainty. In addition, EBS recommends that the Commission clarify the scope of the requirement in proposed Rule 36.2(g) that, under some circumstances, MTEFs publicly disseminate trading data, as that requirement applies to wholesale markets.

The comments that follow address EBS's suggestions with respect to the revised Part 35 exemption and the new Part 36 exemption for transactions on an MTEF.

1. The Proposed Part 35 Exemption.

EBS applauds the Commission's decision to revise and update the Current Swap Exemption. In particular, by eliminating the requirement that covered transactions not be "part of a fungible class of agreements standardized as to their material economic terms," the Commission has removed a significant source of legal uncertainty in light of the growth of the OTC derivatives market and the increased standardization of certain OTC derivatives products, particularly interest-rate products. In addition, by expanding the scope of the exemption to any "contract, agreement or transaction," the Commission has eliminated the need to analyze whether a particular transaction constitutes a "swap agreement," as defined in the Current Swap Exemption, a determination that itself may create unnecessary uncertainty.

EBS also strongly endorses the proposed nonrepudiation provisions in proposed Rules 35.3(b) and (c), which would, among other features, significantly reduce the risk that a

party to an OTC derivatives transaction could repudiate the transaction or otherwise recover payments made thereunder based on a failure of the transaction to comply with the terms of the new Part 35 exemption. In addition, EBS supports the Commission's determination to permit expressly the clearing of OTC derivatives transactions effected pursuant to Part 35 through clearing organizations regulated by any of a number of qualified U.S. and non-U.S. financial regulators.

EBS would like, however, to suggest several ways in which the revised Part 35 exemption could be further enhanced in a manner consistent with the goals of enhancing legal certainty and facilitating the electronic trading of OTC derivatives.

a. **Credit-Screened Systems.**

The Commission has clarified the definition of MTEF in Rule 36.1 in several beneficial respects, such as by stating explicitly that the definition does not include an electronic communication system on which the execution of transactions results from bilateral communications between the parties, and not from the interaction of multiple orders within a predetermined, nondiscretionary automated trade-matching algorithm. Nevertheless, the proposed definition has a significant limitation, as it may include electronic trading systems that feature so-called "credit screening."

The electronic trading systems of EBS and many other providers include a credit-screening functionality that permits a participant to enter into a transaction on the system only with a counterparty to whom it has explicitly determined to extend credit and who has explicitly determined to extend credit to it. In addition, a transaction on such a system may generally be executed only if the transaction would not cause the aggregate credit exposure of either participant to the other to exceed the lines of credit established by either participant with respect to the other. As a result of this credit screening, bids and offers of a participant may be displayed on the system as actionable only to those other participants with whom the transaction could be executed in accordance with the respective participants' credit parameters.

Because the definition of MTEF in proposed Rule 36.1(b) refers to facilities on which bids and offers are open to *multiple* participants, as opposed to *all* participants (as in the definition under the Current Swap Exemption), the new definition of MTEF may cover electronic systems that incorporate this type of credit screening, whereas the current definition does not. By creating this uncertainty as to whether credit-screened systems would be MTEFs, the revised definition thus also raises the question whether transactions effected on such systems would be eligible for the Part 35 exemption or would have to comply with the Part 36 exemption, which limits the types of transactions that are permitted, among other additional restrictions.

In EBS's view, credit-screened systems should not be characterized as MTEFs. A key characteristic of such trading systems is that transactions may be executed only between parties that have made individual credit determinations based on knowledge of their potential counterparties. In addition, participants on the system will typically have individually negotiated the credit and other significant terms of their relationship with one another prior to entering into

transactions on the system. These features are much more typical of the types of OTC derivatives transactions traditionally eligible for the Current Swap Exemption than of the types of more fungible, anonymous transactions for which the Part 36 exemption is designed.

In addition, EBS believes that credit screening provides an important method of reducing credit risk, and related systemic risks, for transactions that are not submitted for clearing to clearing organizations. Participants must make credit decisions in advance, and transactions that exceed a participant's established credit limits can simply be prohibited. As a result, credit-screened systems provide an additional tool with which firms can monitor and limit their aggregate credit exposure. EBS believes that the Commission should support the continued development and refinement of these arrangements by maintaining their eligibility for the Part 35 exemption.

Accordingly, EBS recommends that the final rules contain an express exclusion from the definition of MTEF for electronic trading systems that permit participants to enter into bilateral transactions and incorporate electronic credit screens or filters that prevent any participant from executing a transaction with another participant unless each participant has approved the extension of credit to the other prior to entering into the transaction. This change would ensure that the revised Part 35 exemption would remain available for transactions on such systems.

b. Definition of Eligible Participant.

EBS believes that the definition of eligible participant, which is based on the existing "eligible swap participant" definition, could be clarified in certain respects. In particular, the bank category should expressly include foreign banks and branches or agencies of foreign banks. Foreign banks are significant participants in the OTC derivatives markets, and the Commission should clarify their status as eligible participants under the Part 35 and Part 36 exemptions.

c. Agency Transactions.

The revised Part 35 exemption is inconsistent with proposed Part 36 as to the treatment of agency transactions. EBS believes that Part 35 should be clarified to conform to Part 36, which provides that an eligible participant may enter into an exempt transaction for its own account or as agent on behalf of another eligible participant. If agency transactions are permitted on an MTEF, there is no justification for excluding such transactions when they are not conducted on a trading facility.

2. The Proposed Part 36 Exemption.

EBS strongly supports the Commission's proposed Part 36 exemption, which would provide legal certainty for OTC derivatives transactions effected on an MTEF and thereby eliminate a significant limitation of the Current Swap Exemption. In proposing this exemption, the Commission has recognized the importance of, and sought to facilitate, electronic trading, a

key direction in which OTC derivatives markets are moving. Given that electronic trading systems have already begun to be developed in other jurisdictions where the legal uncertainties present in the United States have not existed, the proposed exemption would help ensure that these facilities, and the benefits they provide, would be available to U.S. market participants as well. As with the revised Part 35 exemption, EBS also endorses the nonrepudiation provisions for transactions pursuant to Part 36 and the Commission's decision to permit clearing of Part 36-exempt transactions.

EBS believes, however, that the applicability of the transparency provision in Part 36 to certain types of trading facilities, such as wholesale markets, is unclear. In addition, in EBS's view, the scope of the Part 36 exemption is, in certain respects, insufficient to permit U.S. market participants to take full advantage of the benefits of electronic trading of OTC derivatives.

a. Transparency.

Part 36 would require that if the Commission determines that an MTEF "serves as a significant source of price discovery for an underlying commodity," the MTEF must disseminate, on a daily basis, trading volume, price ranges and other data "appropriate to that market" as provided in the Commission's order. EBS believes that it is essential that Commission provide further guidance as to how this requirement would apply to MTEFs that are wholesale or tiered markets.

Trading facilities on which access is limited to certain types of professional or wholesale market participants may serve a price-discovery function for those participants, but not for end-users, other professionals who do not participate on that facility or the general public. As a result, price dissemination for such markets is typically restricted as a commercial matter to participants in that market (or, in the case of a tiered market that distinguishes between classes of participants, to participants in the relevant tier). EBS believes that there is no public policy justification for requiring an MTEF of this type operating pursuant to Part 36 to disseminate wholesale market prices to the general public or otherwise beyond the relevant class of participants. EBS requests that the Commission clarify that proposed Rule 36.2(g) would impose no such requirement.

In addition, EBS recommends that the Commission clarify that the price dissemination requirement would be applicable only to an MTEF with respect to transactions that constitute futures contracts or commodity options that are otherwise subject to the Commodity Exchange Act.

b. MTEF Definition.

As noted above, EBS believes the definition of MTEF should be clarified to expressly exclude electronic systems that feature credit screening.

Ms. Jean A. Webb, p. 6

c. **Range of Underlying Commodities.**

EBS generally endorses the comments submitted to the Commission by the Ad Hoc Coalition of Commercial and Investment Banks and the International Swaps and Derivatives Association, Inc., with respect to the range of transactions permitted on MTEFs under the Part 36 exemption.

Conclusion

The Proposed Rules represent a significant step toward enhancing legal certainty for, and facilitating electronic trading of, OTC derivatives. EBS strongly supports the Commission's efforts in this regard and urges the adoption of the Proposed Rules as soon as practicable, subject to the recommendations set forth above.

In particular, EBS respectfully requests that the Commission revise the definition of MTEF to expressly exclude credit-screened electronic trading systems where parties must make bilateral determinations to extend credit to particular counterparties. At a time when the Commission has proposed to significantly reduce the legal uncertainty faced by OTC derivatives transactions, it should not introduce a new element of uncertainty as to the status of a type of electronic trading system that is potentially quite useful in the reduction of credit and systemic risks. In addition, EBS requests that the Commission clarify that the transparency obligation in proposed Rule 36.2(g) would not require a wholesale market to disseminate trading data to the general public.

EBS appreciates the opportunity to comment on the Proposed Rules and stands ready to work with the Commission and other interested parties to advance this rulemaking initiative. If the Commission or its staff has any questions regarding this letter, please do not hesitate to contact the undersigned (tel. 212-225-2820) or Geoffrey B. Goldman (tel. 212-225-2234).

Very truly yours,



Edward J. Rosen

cc: The Honorable William J. Rainer
The Honorable David D. Spears
The Honorable Barbara Pedersen Holum
The Honorable James E. Newsome
The Honorable Thomas J. Erickson