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October 13, 1998

COMMENT

**VIA FACSIMILE, FEDERAL EXPRESS AND ELECTRONIC MAIL**

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

COMMODITY FUTURES  
TRADING COMMISSION  
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Re: OTC Concept Release 63 FR 26114 (May 12, 1998)

Dear Ms. Webb:

The New York Mercantile Exchange ("NYMEX" or the "Exchange") appreciates the opportunity to comment, on its own behalf and on behalf of its wholly-owned subsidiary, Commodity Exchange, Inc., on the Commodity Futures Trading Commission's ("CFTC" or the "Commission") recent Concept Release pertaining to over-the-counter ("OTC") derivatives markets.

NYMEX is a not-for-profit corporation organized under the laws of the state of New York. It has been designated by the Commission as a contract market for the trading of numerous commodity futures and commodity futures option contracts. NYMEX is the largest exchange in the world for the trading of futures and option contracts based on physical commodities. Public investors in our markets include institutional and commercial producers, processors, marketers and users of energy and metals products.

**I. Introduction**

In early 1993, the Commission promptly exercised its newly granted exemptive authority pursuant to the Futures Trading Practices Act of 1992 ("FTPA") by issuing new Part 35 ("Exemption of Swap Agreements") and by amending Part 34 ("Regulation of Hybrid Instruments"). Certain of the Commission's rationales for issuing the Concept Release emphasized the changes in OTC markets that have occurred since that time. The Exchange believes that it is reasonable and prudent for the Commission periodically to take stock and assess whether its current regulatory structure is appropriate in light of the realities of the current marketplace. The Exchange

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*The New York Mercantile Exchange is composed of two divisions. The NYMEX Division offers trading in crude oil, heating oil, unleaded gasoline, natural gas, electricity, propane, platinum, and palladium. The COMEX Division offers trading in gold, silver, copper, and the Eurotop 100<sup>®</sup> index.*

commends the Commission for asking such pertinent questions in an effort to resolve the difficult issues that have evolved in this area.

As detailed below, NYMEX believes the evidence available at this time does not support the imposition by the CFTC of material additional regulation relating to the formation and execution of OTC transactions. Additionally, we believe that swaps clearing facilities may offer significant benefits to market participants and the Exchange urges the Commission to develop a regulatory framework to support the establishment of such entities. However, the Exchange strongly believes that, as a matter of regulatory policy, the systemic risks and fiduciary issues that would emerge by the creation of such centralized facilities must be addressed through appropriate regulatory safeguards which are uniformly and prospectively applicable to all participants. Finally, the Exchange believes that, in the spirit of the Commission's goal of "fair competition" through "even-handed regulation," the Commission should learn from the lesson of the OTC markets, which have functioned outside the carefully circumscribed system of regulation in an efficient manner without significant systemic problems. Consequently, the Commission should undertake a review of the existing regulations which apply to the domestic futures exchanges so that the costs of regulation do not inhibit the competitive posture of the exchanges and the flexibility with which the exchanges can respond to developments and customer needs in the cash and OTC markets.

While this comment letter discusses these themes and, in doing so, responds to many of the Commission's questions posed in the Concept Release, the Exchange has also appended to this letter specific responses to the Commission's questions.

## **II. With limited exception, additional regulation of the existing OTC market is not necessary.**

A main focus of the Concept Release is whether there is a need for additional CFTC safeguards on OTC derivatives. While NYMEX discusses the need for regulation of certain developments in the OTC industry, such as swaps clearing facilities, in Section III. below, NYMEX believes that the evidence available at this time does not support the imposition by the CFTC of material additional regulation relating to the formation and execution of OTC transactions. The Part 35 exemption, which exempts eligible transactions and participants from most requirements of the Commodity Exchange Act ("Act") and from the Commission's regulations (with the principal exception of anti-fraud and anti-manipulation prohibitions), applies only to swap agreements transacted between "eligible swap participants." That term, as defined by Part 35, generally limits the availability of the exemption to financial institutions (including futures commission merchants and broker-dealers), floor traders and

corporations and natural persons who have a net worth in excess of a threshold level used as an indicator of financial sophistication.

In so defining eligible swap participants, the Commission intended to restrict the scope of the exemption to those persons and entities possessing the sophistication, financial resources and the ability to bear the risks of participating in OTC markets. In discussing whether there exists a need for additional regulation of the OTC markets, the Commission, in the Concept Release, noted that there has been an increase in recent years "in the number and size of losses even among large and sophisticated users."<sup>1</sup> The Exchange believes that the mere recitation of certain losses in OTC markets, including a number of well-publicized losses of some size, is not particularly probative on the issue of the need for additional federal regulation of such markets. Losses occur every day in every financial market. In this regard, as Chairperson Born noted in recent Congressional testimony, "[o]bviously, regulation cannot and should not seek to eliminate market losses. . . ."<sup>2</sup> Some of these prior market losses may have raised sales practice concerns.<sup>3</sup> Yet, the appropriate public policy question to consider is whether a problem identified in certain OTC transactions is so systemic that private market regulation no longer may be viewed as adequately addressing that problem.<sup>4</sup> At this time, the available evidence does not support such a finding for trading activity

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<sup>1</sup>In this connection, while citing a 1997 GAO Report on OTC derivatives that listed a number of end-user losses, the Commission noted that "[s]ome of these transactions involved transactions that are not the subject of the CEA." 63 FR 26114 at 26115, n. 6 (May 12, 1998).

<sup>2</sup>Testimony of Brooksley Born, Chairperson, Commodity Futures Trading Commission, Concerning the Over-the-Counter Derivatives Market, Before the U.S. House of Representatives Committee on Banking and Financial Services, July 24, 1998, p. 15.

<sup>3</sup>Of course, as swap transactions that are exempted by Part 35 are still subject to the Commission's anti-fraud prohibitions, fraud by one counterparty in a transaction falling within the jurisdiction of the Commission could be addressed through a CFTC enforcement action.

<sup>4</sup>The Exchange also believes that it may be useful to consider the losses identified in the context of the overall market. In the Concept Release, the Commission, relying upon a 3% calculation of the notional amount of OTC derivatives to estimate the market value of such transactions, indicated that, based upon data provided by the International Swap Dealers Association, the worldwide market value of OTC interest rate swaps, currency swaps, and interest rate options was over \$860 billion as of June 30, 1997. 63 FR 26114 at 26115, n. 6 (May 12, 1998).

occurring in OTC markets.

In the Concept Release, the Commission also observed that “[m]arket losses by end-users may lead to allegations of fraud or misrepresentation....”<sup>5</sup> Clearly, eligible swap participants, which contract to enter into swaps transactions and which later believe that their counterparty may have engaged in misrepresentation or fraud, have or should be presumed to have the wherewithal to obtain legal redress for such contract law claims in the courts. Recourse to traditional legal remedies and use of various measures to reduce the likelihood of loss or default, such as insisting that one's counterparties have an adequate credit rating, have sometimes been referred to as “private market regulation.” It should also be noted that, in a highly competitive market, such as the swaps market, reputational risk can be a significant consideration because the consequences of damages to a dealer's reputation from fraud allegations can be substantial. Consequently, the Exchange believes that these factors would obviate the need for additional material governmental regulation in the OTC markets.

**III. Certain developments in the OTC market, particularly the potential use of centralized swaps facilities and MTEFs, require appropriate regulatory safeguards which must be uniformly and prospectively applicable to all participants.**

In the Concept Release, the CFTC posed a number of specific questions about certain aspects of Part 35, particularly with respect to swaps clearing facilities and multilateral transaction execution facilities (“MTEFs”).

**A. Clearing Facilities**

The Exchange believes that swaps clearing facilities will provide significant benefits to participants using such a facility, including allowing such participants to reduce the degree of counterparty credit risk in their swaps books. Thus, permitting swaps clearing facilities may well promote market growth and assist U.S. participants in

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<sup>5</sup>In adopting the final rules for Part 35, the Commission noted an article that had reviewed data on swaps transactions for the previous decade; based on this information, the Commission found that “the number of defaults appear to be low.” ¶ 25,539, pp. 39,594-95. Comm. Fut. L. Repr. (1992-1994 Transfer Binder). The Concept Release does not discuss this question. In this regard, actual losses to institutional counterparties in recent years from dealer defaults in OTC markets have been negligible. Alan Greenspan, Address Before the Financial Markets Conference of the Federal Reserve Bank of Atlanta (February 21, 1997), *reprinted in* Futures Derivatives & Law Report (April 1997) at 11.

remaining competitive. (Question # 34). The nature of the swaps market has evolved such that the development of such clearing facilities is appropriate and should be encouraged by the Commission. Swaps have evolved into instruments which are similar and increasingly standardized and thus are more conducive to being cleared by a clearing mechanism. NYMEX, however, believes strongly that this centralization of the risk management function means that the CFTC should require such facilities to have the core financial, market integrity and other prudential safeguards identical to those used by futures exchanges to address financial risks and customer fiduciary issues associated with that clearing function.

The Exchange believes that it is critically important for the Commission to formulate standards that would ensure that swaps clearing facilities are maintained with prudent risk management standards designed to reduce systemic risk and also be subject to other safeguards to support the fiduciary obligations of such facilities. Moreover, this should not be done in a piecemeal manner. As the Exchange stated in its recent comment letter on the application of the London Clearing House for a Section 4(c) exemption for its swaps clearing facility, the Commission must establish uniform standards prospectively applicable to all OTC derivatives clearing facilities, whether or not such facilities are run by regulated futures exchanges and that would provide interested applicants with appropriate guidance. It is NYMEX's opinion that independent third parties which are not otherwise in the swaps business would be the most effective operators of such facilities.

In this regard, in the 1993 CFTC OTC Derivatives Report, the Commission stated that the regulatory issues presented by a facility for clearing swaps would depend materially upon the facility's design, such as, for example, the extent to which the construction of such a facility is consistent with the minimum standards for netting systems recommended by the Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries ("Lamfalussy Report").<sup>6</sup> The

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<sup>6</sup>The Lamfalussy Report set forth the following standards:

1. Netting schemes should have a well-founded legal basis under all relevant jurisdictions.
2. Netting scheme participants should have a clear understanding of the impact of the particular scheme on each of the financial risks affected by the netting process.
3. Multilateral netting systems should have clearly-defined procedures for the management of credit risks and liquidity risks which specify the respective responsibilities of the netting provider and the participants. These procedures should also ensure that all parties have both the incentives and the capabilities to manage and contain each of the risks they bear and that limits are placed on the maximum level of credit exposure that can be produced

Commission sought comment concerning the usefulness of the Lamfalussy standards for swaps clearing facilities.

NYMEX believes that these standards are prudent and provide a useful starting point for the standards to be considered by the Commission in the development of swaps clearing facilities. In this regard, the Exchange has a few suggestions concerning the Lamfalussy Report standards. These suggestions address the types of risk management tools that should be used by a clearing facility (Question #38) and the standards for admission as a clearing participant (Question #37).

Standard #3 refers generally to procedures for the management of credit and liquidity risks. Given the potential for systemic risk to the financial system from registered transactions, NYMEX believes that it is especially appropriate for the CFTC to propose explicit financial safeguards consistent with sound risk management procedures applicable to regulated derivatives clearing. In particular, the CFTC should require swaps clearing facilities to collect both original and variation margin and settle on a daily basis using prudent mark-to-market mechanisms.

While Standard #4 would require daily settlement only in one setting, NYMEX believes that positions should be marked-to-market on a daily basis. It is true that swap transactions typically do not require counterparties to remit payments to each other on a daily basis and instead involve an exchange of payments on a more periodic basis, such as at the end of a calendar quarter. However a clearing house that guarantees performance, as it has historically been articulated, is acting as the buyer to every seller and as the seller to every buyer. Accordingly, such a clearing house is assuming a considerable degree of market risk. To limit its market risk exposure, it is prudent for a clearing house to limit the duration of its exposure until the assets can again be marked-to-market. In addition, increases in the duration of the time horizon also increase significantly the difficulty of engaging in accurate measurement of the risk to a clearing house over this longer time horizon. In addition to requiring daily marking-to-

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by each participant.

4. Multilateral netting systems should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single net-debit position.

5. Multilateral netting systems should have objective and publicly-disclosed criteria for admission which permit fair and open access.

6. All netting schemes should ensure the operational reliability of technical systems and the availability of back-up facilities capable of completing daily processing requirements.

market of positions held at the clearing house, the CFTC also should consider requiring that all variation margin payments be made in cash.

With regard to risk measurement conducted as part of this daily marking-to-market, the CFTC also needs to formulate standards concerning the price basis that will be used as a basis for settlement. Absent such standards, a price basis may be used that would not accurately reflect the true market value of the swap, e.g., due to causes such as cash market illiquidity in the price data being used. This could make the clearing house more vulnerable to increased levels of risk not properly reflected in the variation margin payments. To minimize the likelihood of this outcome, the Commission should formulate appropriate standards. In this connection, even after issuing an exemption for a proposed swaps clearing facility, the Commission would have a continuing obligation to ensure that the prices for these products were not susceptible to distortion (or manipulation) and to protect the U.S. entities (and their customers, if any) participating in the exempted facility.

Of course, the CFTC has already conducted such an analysis for those contracts that have been designated as contract markets by the CFTC. Accordingly, NYMEX suggests that the prices of CFTC-approved contracts with sufficient levels of trading volume and open interest should be readily accepted as safe and reliable sources of price data to be used by a swaps clearing house in marking swaps positions to market. In this regard, the Commission should formulate standards relating to the appropriate levels of trading volume and open interest of CFTC-approved contracts for purposes of this risk measurement process.

Other sources of price information, while less preferable, may also be found to be acceptable upon review. Therefore, the Commission also should formulate standards regarding the criteria to be met for alternative sources of price data. NYMEX suggests that such standards might include the reliability of these data sources, the frequency that such data are disseminated, i.e., daily, and the degree of acceptance of such sources by market participants.

Standard #5 of the Lamfalussy Report requires that systems have objective and publicly-disclosed criteria for admission which permit fair and open access. This standard is also consistent with Section 15 of the Act, which requires the Commission to endeavor to take the least anti-competitive means of achieving the objectives of the Act. Perhaps the most basic means of addressing counterparty credit risks is to deal only with creditworthy counterparties. Clearing houses traditionally have sought to ensure that their members are creditworthy by establishing a set of financial requirements for membership. In most instances, membership is restricted to entities that meet specified minimum capital requirements.

NYMEX believes that the Commission's standards should clarify that the appropriate analysis for determining eligibility for participation in a swaps clearing facility should involve primarily the financial integrity and commercial standing of the entity and, perhaps, prior experience by that entity with swaps transactions. The CFTC's proposed standards should clarify that it is inappropriate for public markets to exclude entire classes of possible participants because of their line of business.

Finally, the standards to be established by the Commission for exemptive relief for proposed swaps clearing facilities should be no less onerous than the standards imposed by the Commission upon domestic clearing organizations. No clearing system can be made failsafe, but to protect U.S. entities participating in foreign swaps clearing facilities, the Commission's review should focus upon those financial and operational safeguards that will act to preserve market integrity.

In undertaking a review of an exemption petition to establish a swaps clearing facility, it is appropriate for the Commission to consider whether another federal regulatory regime or a foreign regulatory regime would be applicable to the proposed facility. (Question #40). However, in doing so, the CFTC also needs to be mindful of possible differences in regulatory approaches with these other regulatory regimes. For example, a proposed swaps clearing facility might call for the commingling of futures and swaps margin funds. The Commission should carefully consider whether this commingling is appropriate for U.S. entities, or whether such entities might be better protected under an approach that segregates futures margins from swap margins but permits some manner of cross-margining.

#### B. MTEFs

In the Concept Release, the Commission requested comment concerning the existing restriction against exempted transactions being executed on MTEFs. In particular, the Commission asked whether the definition of MTEFs should be changed in any way to provide more clarity. (Question # 41). MTEF is not a defined term in Part 35. However, in the Commission's Federal Register release announcing the adoption of final rules for Part 35, the Commission stated that a MTEF was " a physical or electronic facility in which all market makers and other participants that are members simultaneously 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."<sup>7</sup> As is further discussed below, the Exchange believes that, to the extent that such facilities trade products and use trading mechanisms and procedures which are the same as or are barely distinguishable from futures exchanges, they should be

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<sup>7</sup>58 FR 5587 at 5591 (January 22, 1993).

subject to the same regulatory scheme as the organized futures exchanges.

The lynchpin of an exemption for many OTC products, including swaps, is the fact that they are principal-to-principal transactions in which the terms of the transaction are individually negotiated and in which creditworthiness of the counterparties is a material consideration. A "blind" match system, the essence of the definition of an MTEF, is not consistent with the criteria used as the basis for exemption from regulation. In addition, the existence of MTEFs is conducive to the development of standardized, fungible products which may in fact be indistinguishable from futures contracts.

Consequently, the distinction between such OTC products traded on MTEFs and regulated transactions becomes blurred and would put the futures exchanges at a significant competitive disadvantage if the regulatory environment in which they operate is not modified to respond to the OTC regulatory environment. Electronic trading systems developed and operated by futures exchanges are subject to a myriad of regulations. To the extent that MTEFs involve the use of products and trading procedures that are the same as or are only minimally different from those in use by the futures exchanges, the Exchange submits that these facilities should be registered as futures exchanges and thus subject to identical regulation.

Section 4(c)(1) of the Act states that the Commission may use its exemptive authority under that provision "[i]n order to promote responsible economic or financial innovation and fair competition." According to the Conference Report for the FTPA, Congress intended that "the Commission, in considering fair competition, will implement this provision in a fair and even-handed manner to products and systems sponsored by exchanges and non-exchanges alike."<sup>8</sup> It would be fundamentally unfair for the Commission to permit use of MTEFs for exempted transactions but not also require such facilities to meet the same standards presently imposed on equivalent exchange facilities. This inherently unfair outcome would be completely inconsistent with Congressional intent on this issue. Moreover, as Chairperson Born noted in a recent interview, similar activities should be regulated similarly and to do otherwise would be a violation of the due process clause of the Fifth Amendment.<sup>9</sup>

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<sup>8</sup>H.R. Report, No. 978, 102d Cong., 2d Sess. 78 (1992).

<sup>9</sup>Swaps Monitor, Volume 11, number 19 (July 27, 1998).

**IV. The Commission should undertake a review of its existing regulations and exemptive authority so as to provide regulatory consistency between the OTC and the regulated futures markets.**

**A. Need For Reduction of Regulatory Burden**

The Exchange has been steadfast in recognizing the many valuable functions that OTC products provide to users of OTC markets and the innovations that these products have brought to financial markets generally. Over the course of the approximately five years since Part 35 went into effect, the swaps markets have thrived. The dramatic growth of swaps markets over the last five years supports the conclusion that the CFTC, in largely leaving these markets alone and thereby permitting these markets to flourish, struck the appropriate regulatory balance in Part 35 with regard to the swap transactions that are eligible for an exemption.

By comparison, while trading conducted on regulated futures exchanges also provides many benefits to market-users, such markets are subject to a heavy burden of regulation. Specifically, trading conducted on centralized exchanges provides market participants with price transparency and the elimination of counterparty credit risk and also provides market transparency to regulators with oversight responsibilities. Yet it is universally acknowledged that regulated futures exchanges are subject to a pervasive scheme of regulation. Certain requirements provide a benefit and would be followed by exchanges regardless of whether or not such requirements were required by federal regulation. Other requirements add tremendous cost to the operation of an exchange, do not provide a corresponding level of public benefit, and, in many cases, can easily be circumvented by use of the OTC markets.

NYMEX believes that an important lesson can be learned from the experience of the OTC markets. These markets have functioned outside of a carefully circumscribed system of regulation in an efficient manner and, by providing unique and innovative financial tools, have significantly contributed to the promotion of the public interest without significant systemic problems. The greater freedom to design new products relative to more heavily regulated exchange-traded markets has permitted OTC markets to respond quickly to changing market demands.

NYMEX contends that such an approach could be used in regulation of the futures markets in that certain existing regulatory requirements hinder the ability of futures markets to respond effectively in a rapidly-evolving marketplace. In this regard, the grant to the CFTC of exemptive authority under Section 4(c) does not distinguish between exchange and off-exchange products. In other words, in 1992 Congress not only gave the CFTC authority to exempt OTC transactions but also provided it with express statutory authority to exempt exchange-traded products from relevant

provisions of the Act.

In recent testimony, the CFTC Chairperson observed that "the CFTC over the past 18 months has been engaged in a comprehensive regulatory reform effort designed to update, to modernize and to streamline its regulations and to eliminate undue regulatory burdens."<sup>10</sup> Chairperson Born added that "[t]he Commission's review of its regulatory system would be incomplete in an important respect if it did not address the Commission's rules regarding OTC derivatives."<sup>11</sup> The CFTC has indeed been very active in issuing regulatory proposals and concept releases over the last 18 months; however, relatively few of these efforts have been directed at a wholesale review of regulation generally applicable to contract markets. The three most recent major regulatory proposals under review by the Commission, the London Clearing House ("LCH") SwapsClear proposal, the Concept Release on the Placement of Terminals of a Foreign Board of Trade in the United States and this proposal, in most instances, seek to "lower the regulatory bar" to permit new types of businesses in the United States and to determine how these businesses should be regulated. The core issue, however, of how the type and level of regulation imposed on domestic exchanges must change to respond to these new types of businesses is not addressed. The Exchange submits that the Commission's review of its regulatory system will not be complete until it modernizes and streamlines the regulations imposed upon futures exchanges. The Exchange believes that it is especially critical that there be consistent regulatory treatment for trading whether that trading is conducted on an exchange, in the OTC markets, or by a foreign board of trade trading a U.S.-based product through an electronic terminal in the U.S.

There is a critical need "to eliminate undue regulatory burdens" applicable to trading on futures exchanges. In this regard, out of the 75 questions contained in the Concept Release, only one question, which was at best an indirect reference and which pertained to possible appropriate terms and conditions for multilateral transaction execution facilities (question #43), asked generally whether elements of Part 36 should be applicable to such facilities. In the text of the Concept Release, the CFTC also noted that "[p]roposals for modification of Part 36 are welcome." However, the Exchange believes that the Commission's reconsideration of Part 36 should be undertaken in a manner that is at least as thoughtful and thorough as the CFTC's OTC Concept Release. NYMEX respectfully submits that a major, if not the central

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<sup>10</sup>Testimony of Brooksley Born, Chairperson, CFTC, Concerning the Over-the-Counter Derivatives Market, Before the U.S. Senate Committee on Agriculture, Nutrition and Forestry, July 30, 1998 ("July 30 Testimony"), p. 11.

<sup>11</sup>July 30, 1998 Testimony, p. 12.

unfinished challenge, that remains to be met by the CFTC is to apply the exemptive authority granted by Congress to exchange-traded transactions with the same creativity and vision that it has displayed for OTC products.

B. Principles for Regulatory Reduction

In exploring the contours of applying the exemptive authority which should be applied to the regulated futures exchanges, there are certain basic precepts which, in NYMEX's opinion, should be considered by the Commission. The extent of CFTC-mandated jurisdiction over contract markets to impose and enforce standards and procedures, including reporting and recordkeeping requirements and to require rules and products to be subject to its prior approval, should be founded on and limited by its primary statutory duties: to ensure financial integrity, market integrity and price transparency and customer protection.

To the extent that a contract market as a commercial competitive entity designs products or develops the means and practices for delivering those products (as long as those commercial products are fully disclosed and applied in a non-discriminatory way), the contract market should be free from regulatory intrusion or oversight. Therefore, at a minimum, innovative trading practices and the terms and conditions of new futures, options or hybrid products developed by an exchange should not be subject to prior review. These activities or practices by the contract market which do not implicate the core protections mentioned above should be free from Commission oversight and should be left to the discretion and sound business judgment of the contract market so long as such activities and practices are fully disclosed to the public.

"Regulatory relief" has been a major issue for the domestic exchanges since the OTC swaps and hybrid exemptions were first enacted. As they have evolved, swaps transactions have become an important part of the risk management complex of derivatives. In fact, along with the futures and options markets, they have thrived, with anecdotal evidence suggesting at a greater pace than regulated markets.

NYMEX has consistently taken the view that swaps markets are best left to evolve and develop under the current exemption scheme with certain governing restrictions. That being said, however, NYMEX also believes that in certain areas regarding the operations of the futures exchanges that philosophically do not implicate the regulatory interests designed to assure market and customer integrity, NYMEX also would benefit from certain regulatory relief as well. The specifics are spelled out below, as is a general statement of policy that can govern market deregulation while preserving the integrity that Congress and the American public have come to expect from futures and options exchanges.

Under the current regulatory scheme, any rule or by-law to be adopted by an exchange must pass through a CFTC filing process, a waiting period, and too frequently a review process as well. We accept this scheme as it pertains to the exchanges' fiduciary obligations of fair dealing and honesty that NYMEX owes to its customers and members governing equal access to the marketplace, the prudential management of risk, and the protections which assure that markets are free from manipulation and reflect fundamental value.

However, there is a third category of rule-making which does not affect the core of our fiduciary duties, or does so only in the most indirect and tangential ways as not to be material. These rules fall into the category which we call "operations," a term intended to cover the daily operations of business on the floor; the changes to initial contract terms and conditions introduced through an accepted practice of industry input; market innovations that seek to broaden the usefulness of the exchange by inviting off-exchange transactions into the regulated marketplace; the administration of the self-disciplinary process; innovations in trading methods that seek to provide liquidity to newly conceived markets; and in a broad context, rules that eliminate unnecessary impediments to product and market innovations that do not materially impact, on balance, the fiduciary duties of the exchange to its customers and members and the public. These rules snugly fit into a set of autonomous issues that are either operational or customer service oriented in nature.

To illustrate, there are number of initiatives designed by the Exchange to respond to needs of its market participants which the Commission, through its actions relative to these proposals, prevented, delayed or severely limited the implementation without an articulated basis which implicated the performance and fulfillment of our expected fiduciary duties. These include:

1. The failure over a nearly three-year time frame to approve Exchange of Swaps for Physicals ("EFS") transactions, which are intended to incorporate the swap trades left outside the regulatory scheme into regulated risk management instruments. EFS transactions have been permitted on the Finex and the IPE for several years with no instances of regulatory harm;

2. The failure to allow for post-close trading within the full price range of the close. Instead, there is an arbitrary limitation on pricing that sometimes permits the mechanism to be useful, but often makes it useless;

3. The failure to allow for post-close trade matching under the aegis of the floor committee to avoid for price violations of customer orders in the closing range, and to maintain orderly markets;

4. The requirement of overly burdensome and intrusive hearing standards for minor trading floor violations (e.g., decorum and attire standards), thus impeding self-regulation with government style due process requirements;

5. The lengthy prior review process for many types of proposals. While the Exchange acknowledges that the Commission has endeavored to shorten the review period for certain proposals, such as contract market designations, there is no consistency to the rule review periods so that it frustrates the ability of an exchange to implement proposals rapidly and with a coordinated strategic purpose. For instance, we believe that the Specialist Market Maker program, which was designed to introduce liquidity to fledgling contracts such as electricity, should have been subject to no, or minimal, prior review.

6. The micro-review of technology in our electronic trading system that required sub- 2 second response time at a cost of many millions of dollars to provide for perfect market equality. Recently, however, an "exchange" with no history that chose to open an Internet market, which is notorious for its imperfect market equality, is being given serious consideration to use that technology platform because the disclosure of its limitations to the public cleanses any issue of regulatory concern. This is a standard of regulatory restraint that should be copied in many other areas of Exchange rulemaking. The public should be permitted to decide if the exchange's operational affairs are to its liking or not in each of the cases cited above and many more that have not yet arisen. Then, a sensible balance will have been struck.

As it now stands, many initiatives are reviewed in a subjective context, which prevents the Exchange from firmly predicting the time and costs of introducing such proposal. In the example cited above, the statute and regulations do not mandate a 2-second response time. That was a figure selected by Commission staff and imposed on us. Now, there appears to be a prospective change of heart. With the next generation of NYMEX ACCESS<sup>sm</sup> coming early next year, will the standard for electronic trading be uniform, sub-2 second response time, or caveat emptor?

In sum, the submission of rules governing each of the foregoing has had a practical and negative impact on the Exchange's ability to innovate and be competitive in a marketplace that is justifiably free from undue regulatory burdens. We respectfully request authority to freely control our "operations" issues, and, with appropriate disclosure, let the market decide whether it wishes to be our customer.

NYMEX intends to file a Section 4(c) exemption request with the Commission in the near future that sets forth a request for exemption in a broad area of "operations" and hopes for the same thoughtful and expeditious review by the Commission that the Commission has shown recent requests, such as the LCH proposal and the Foreign

Terminals Concept Release.

**V. Summary**

In summary, the Exchange believes that the Commission acted appropriately in using its exemptive authority in 1993 to promulgate Part 35. The Exchange further believes that it is prudent for the Commission to seek information periodically about market changes in order to review the continuing efficacy of exemptions from its regulations. The main points made by the Exchange are as follows:

- a. With limited exception, additional regulation of the OTC markets is unnecessary;
- b. Certain developments in the OTC market, particularly the use of centralized swaps facilities and MTEFs, require appropriate regulatory safeguards which must be uniformly and prospectively applicable to all participants; and
- c. The Commission should undertake a review of its existing regulations and exemptive authority so as to provide regulatory consistency between the OTC and the regulated futures markets.

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NYMEX thanks the Commission for the opportunity to submit comments concerning the Concept Release and would be pleased to furnish additional information in this regard. If you have any questions, please do not hesitate to contact the undersigned.

Respectfully submitted,

  
R. Patrick Thompson  
President

cc: Chairperson Brooksley Born  
Commissioner Barbara P. Holum  
Commissioner James E. Newsome  
Commissioner David D. Spears  
Commissioner John E. Tull, Jr.

## OTC CONCEPT RELEASE QUESTIONS AND NYMEX RESPONSES

Before responding to specific questions below that were included in the OTC Concept Release, NYMEX wishes to note initially that many of these questions seek detailed factual responses and appear to be directed at regular participants in the swaps market and their respective organizations. As these swaps market participants generally neither report to NYMEX nor disclose to NYMEX the details of their transactions, and as the swaps market overall simply is not as transparent as futures markets, some of the information sought by the Commission is not available to the Exchange. In order for NYMEX to provide the Commission with informed comment on the many significant issues raised in the OTC Concept Release, the Exchange therefore has elected to answer only those questions for which it has specific knowledge or expertise, such as its expertise in the trading of energy and precious metal products. Thus, the responses presented below concerning the swaps market generally are based upon the Exchange's understanding of prevailing practices pertaining to commodity swaps.

### Swaps

**1. In what ways has the swaps market changed since the Commission adopted Part 35. Please address: (a) the nature of the products; (b) the nature of the participants, both dealers and end-users; (c) the location of transactions; (d) the business structure of participants (e.g., the use of affiliates for transacting OTC derivatives); (e) the nature of counterparty relationships; (f) the mechanics of execution; (g) the methods for securing obligations; and (h) the impact of the current regulatory structure on any of the foregoing.**

The swaps market has changed in significant ways since the Commission adopted Part 35. A number of these changes were noted by the Commission at the outset of the OTC Concept Release.

- (a). As noted in the OTC Concept Release, swaps products have proliferated, with some products becoming increasingly standardized. In particular, there has been a proliferation in recent years of "look-alike" OTC contracts that basically duplicate the essential terms of an existing exchange-traded futures contract, e.g., NYMEX's Light Sweet Crude Oil futures contract.
- (b). The market has continued to grow over the last five years. In part, this growth reflects the fact that, as the CFTC indicated in the OTC Concept Release, "[n]ew end-users of varying levels of sophistication have begun to participate in this market." These market participants also have varying levels of creditworthiness.

- (h) The impact of the CFTC's current regulatory structure for swaps upon regulated futures markets, which highlights the critical need for regulatory consistency between the OTC and the regulated futures markets, is discussed at length in the attached comment letter and shall not be repeated here. With regard to the impact of the current swaps regulatory structure on the changes noted in subsections (a) and (b) above, the variability in creditworthiness of some of the more recent swaps market participants has had an impact upon the credit lines and limits governing the activity undertaken by some swaps dealers. Consequently, it is the Exchange's understanding that there is strong interest, from both dealers and end-users, in an appropriately designed and regulated facility that would permit the clearing of swaps.

## **2. What are the mechanisms for disseminating the prices for swaps transactions?**

Some brokers and dealers will provide bid and offer information upon request and/or provide sheets with bid-offer spreads for popular swaps. This information is reported by some trade press, although not on a real-time basis. In addition, in April 1998, the International Swaps and Derivatives Association ("ISDA"), in connection with Reuters PLC and Intercapital Brokers Limited, launched an electronic screen service that provides swap quotes for four currencies (French francs, Deutschemarks, Japanese yen and U.S. dollars) in maturities of one through ten years.<sup>1</sup> Thus, at present, it is the Exchange's understanding that the real-time dissemination of prices for swaps transactions is not the current convention in the swaps market.

Recently, the Exchange has become aware that several online systems have been making an effort to provide swaps quotes on a real-time basis. The instruments for which such quotes are provided generally are quite standardized. The recent activities of these online systems appear to be a pronounced trend toward such real-time dissemination of swaps quotes and prices for these standardized instruments.

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<sup>1</sup>The service obtains rates for cash-settled swap options from dealers in Europe, the U.S. and Japan. The quotes are obtained from market-makers at 11:00 a.m. local time in London and New York and at 10:00 a.m. and 3:00 p.m. local time in Japan. The rates are displayed approximately one half-hour later each business day on a Reuters screen.

**3. Does the swaps market serve as a vehicle for price discovery in underlying cash markets? If so, how? Please describe.**

At this time, NYMEX does not believe that the swaps market generally serves as a vehicle for price discovery in underlying cash markets. However, as noted above, there is a clear trend toward greater dissemination of swaps prices, including through use of electronic media. Hence, it is possible to envision that the swaps market may serve in the future as a vehicle for price discovery in underlying cash markets. If that becomes the case, the Commission should examine the regulatory means that would be necessary to assure the integrity of those prices.

**4. To what extent is the swaps market used for hedging? To what extent is it used for speculation? Please provide details.**

At least 83% of recent open interest in NYMEX's largest energy futures contracts can be attributed to firms engaging in hedging. These data are available in part because of the position reporting requirements associated with trading on NYMEX. Since such reporting requirements are not applicable to exempted swaps transactions, the extent to which the swaps market is used for hedging is not clear. However, if one assumes that trading activity in the swaps market is correlated with trading activity in energy futures markets, then it may be possible that perhaps 80% or more of commodity swaps involve hedging. As to the remaining approximate 20% of swaps transactions, some of these transactions are executed as speculative trading activity. In addition, on an anecdotal level, the Exchange has been informed that some of this speculative swaps trading involves participants seeking to avoid the transparency of the regulated futures markets.

**5. Is there a potential for transactions in the swaps market to be used to manipulate commodity prices? Please explain.**

Yes, there is a potential for transactions in the swaps market to be used to manipulate commodity prices, although such potential would appear to arise only in combination with the accumulation of a controlling position in the cash market.

**6. To what degree is the swaps market intermediated, i.e., to what extent do entities**

**(a) act as brokers bringing end-users together?**

**(b) act as dealers making markets in products?**

**Please describe the intermediaries in the market and the extent and nature of their activities.**

The swaps market includes brokers, dealers, and dealers who also act as brokers. In addition to customers to the dealers and brokers, there are major commercial entities, such as merchants "in the trade" of the commodity underlying a particular swap, that participate in the swaps market as counterparties to dealers and brokers. The brokers and dealers are frequently commercial banks and investment banks or commercial entities with significant roles in the underlying cash market corresponding to the commodity subject to the swap.

**7. To what extent do swaps market participants act in more than one capacity (e.g., as principal in some transactions and broker in others)?**

Many significant participants in the swaps market act in the dual capacity of both principal and broker.

**8. In light of current market conditions, do the existing Part 35 requirements provide reasonable, objective criteria for determining whether particular swaps transactions are exempted under the CEA? Should the meaning of terms such as "fungible," "material economic terms," or "material consideration" be clarified or modified in any way? If so, how? 9. What steps can the Commission take to promote greater legal certainty in the swaps market?**

In response to questions #8-9, the Commission's Part 35 swaps exemption has now been available for more than five years. While the swaps market continues to grow at a rapid rate, it is fair to say that the market has matured to the extent that a consensus has developed among swaps market participants regarding the meaning of terms such as "fungible," "material economic terms" or "material consideration," and various practices and conventions have developed based on this consensus. Because of these settled practices, such as those related to use of the ISDA Master Swap Agreement and related forms, NYMEX does not believe that additional legal certainty would result from any current attempt by the CFTC to clarify these terms.

**10. What types of documentation are relevant in determining whether a particular transactions falls within the swaps exemption and/or the Policy Statement? Should the Commission set standards in this regard?**

It is the Exchange's understanding that the swaps market also has settled upon the use of certain types of documentation. NYMEX believes that the issue of what are acceptable types of documentation is an issue that is best determined by the market participants themselves and the CFTC should not set standards in this area.

**11. If the current restrictions set forth in the Part 35 requirements negatively affect or potentially limit the OTC market or its development in the United States, what changes would alleviate the negative effects? Should the exemption in Part 35 be broadened in any manner?**

As discussed in detail in the attached comment letter, NYMEX strongly opposes the general broadening of the Part 35 exemption. However, the Exchange believes that it may be prudent for the Commission to issue proposed regulatory standards for prospective uniform application that would permit the operation of swaps clearing facilities under appropriate regulatory safeguards.

**12. What steps, if any, can the Commission take to promote greater efficiency in the swaps market, such as for example, by facilitating netting?**

The Exchange believes strongly that the substantial expansion of the swaps market, with the consequent continuing proliferation of risk exposures, is best addressed on the regulatory level through carefully considered formal procedures incorporating appropriate financial protections, i.e., Commission-approved clearing mechanisms, rather than through informal netting or novation procedures. Among other things, informal netting procedures may not provide regulators and others with sufficient data regarding the extent of risk exposures involved in such procedures for swap transactions exempted under Part 35. Therefore, NYMEX strongly opposes establishment by the CFTC of standards relating to netting or novation that would in effect broaden the Part 35 exemption. However, NYMEX believes that appropriately designed and regulated swaps clearing facilities could promote greater integrity, with the efficiency that follows, in the swaps market.

**13. Are any changes in regulation relating to the design or execution of exempted swap transactions needed to protect the interests of end-users in the swaps market? Are there changes in regulation that would attract new end-users to the market or lead existing end-users to increase their participation?**

Again, the Exchange believes that appropriately designed and regulated swaps clearing facilities could protect the interests of end-users in the swaps market and also may attract new end-users to the market or lead existing end-users to increase their participation.

**14. Should distinctions be made between swaps that are cash-settled and swaps that provide for physical delivery? Please explain.**

Yes, NYMEX believes that regulatory distinctions should be drawn between swaps that are cash-settled and swaps that provide for physical delivery. In

particular, the Commission's Part 35 exemption for swap transactions should not be available for transactions involving physical delivery. In this regard, the Exchange is not aware of any trend favoring the use of swap transactions involving physical delivery.

**15. Should transactions in fungible instruments be permitted under the swaps exemption?**

Commission Regulation § 35.2 provides that, among other things, in order to qualify as an exempted transaction, a swap agreement may not be "part of a fungible class of agreements that are standardized as to their material economic terms. . . ." The material economic terms include terms related to the creditworthiness of the counterparty.

NYMEX is unaware of any effort by the Commission to enforce the prohibition on fungibility for Part 35 exemptions for any aspect of swap transactions. As noted above, over the last five years, many swap agreements have become increasingly standardized. Indeed, for some transactions, such as look-alike contracts that parallel contracts traded on futures exchanges, terms related to the creditworthiness of the counterparty may be the only variables that distinguish such transactions from the look-alike contracts upon which they are modeled. The Exchange believes that the Commission should acknowledge the reality of current commercial practice, which now center upon principal-to-principal transactions between sophisticated investors, and should focus upon how best to address creditworthiness from a regulatory perspective as discussed below in the Exchange's response to question #16.

**16. To what extent should the creditworthiness of a counterparty continue to be required to be a material consideration under the swaps exemption? Please explain.**

Yes, the creditworthiness of a counterparty should continue to be required to be a material consideration under the swaps exemption. The consideration of creditworthiness takes on increasing importance in view of the standardization of most other terms in many swap agreements. NYMEX believes that the creditworthiness of the counterparties has become the most important factor from a regulatory point of view and clearly supports the Commission's consideration of the appropriateness of permitting swaps to be cleared on appropriately regulated swaps clearing facilities.

**Hybrid instruments**

The answers provided above, in response to questions #1-9 concerning swaps,

also are generally applicable to the corresponding questions in questions #17-25 concerning hybrid instruments.

With regard to questions #26-28, the Exchange believes that Part 34 generally has served its regulatory purpose, although, as discussed below, the Exchange favors use of a single definition of sophisticated investor throughout the Commission's regulations.

### **Eligible Participants**

#### **29. Should the current list of eligible swap participants be expanded in any way? Should it be contracted in any way? If so, how and why?**

With the exception of limited technical changes, such as the example presented below in response to question #30, the Exchange is strongly opposed to any change that would significantly broaden the existing exemptions. If the Commission were to broaden the scope of the current exemption along the lines suggested in the OTC Concept Release, including permitting exemptions for fungible products and significantly expanding the categories of eligible swap participants, the end result would be a collapse in the current distinctions between OTC trading activity and exchange-traded activity that are implicit in Part 35. Consequently, the swaps exemption would be extended to instruments and transactions that are substantially the same as exchange-traded products. Such a result would be clearly inconsistent with the Congressional intent underlying the grant to the CFTC of exemptive authority pursuant to Section 4(c) of the Act.

In addition, such an action would increase rather than reduce current legal uncertainty regarding the scope of the Commission's jurisdiction. Under the Act, the CFTC has exclusive jurisdiction, with some exceptions, over futures contracts and options on futures contracts. The term used in the Act to refer to futures contracts, "contracts of sale of a commodity for future delivery," is not defined by the Act, although the term "future delivery" is defined so as to include any sale of any cash commodity for deferred shipment for delivery, *i.e.*, "forward contracts."

The Commission has never provided a definition of the term contracts of sale of a commodity for future delivery, and so the scope of the CFTC's exclusive jurisdiction has never been a clear bright line. Consequently, persons and entities seeking guidance on the scope of a futures contract have been left to reconcile various administrative and judicial decisions and to draw inferences from various Commission pronouncements, such as the 1989 Policy Statement on Swaps. These prior decisions, which often are enforcement cases involving

allegations that an illegal bucket shop has operated to defraud retail customers, have given weight to the use of standardized terms and use of schemes to market the product to the retail public as indicia in determining whether a futures contract exists.<sup>2</sup>

In promulgating Part 35, the Commission was explicit in not making a finding at that time that the transactions that could be exempted under Part 35 were futures contracts.<sup>3</sup> If the CFTC were to expand significantly the scope of the Part 35 exemption, this would only further exacerbate the present lack of clarity regarding what is a futures contract for purposes of compliance with the Act. This could have significant consequences for users of financial markets as the costs of non-compliance with the exchange trading requirement for futures contracts under Section 4(a) of the Act can be quite substantial.<sup>4</sup> In addition, any additional confusion regarding what is a futures contract could complicate the CFTC's enforcement efforts to prosecute bucket shops that prey on the retail public.

**30. Are there currently eligible swap participants who would benefit from additional protections? Are there potential swap participants who are not currently eligible but would be appropriate subject to additional protections? In either case, please describe the types of persons and the types of protections.**

With regard to the Commission's present definition for eligible swap participant, the Exchange has been advised that, as this definition is interpreted by CFTC staff, receipt of oil well royalty payments by a firm would not suffice to make oil production a line of business for that firm if that firm was not actively engaged in the management of the well. Consequently, such a firm would not be able to rely upon the \$1 million net worth standard to qualify as an eligible swap participant but instead would need to have total assets of at least \$10 million. Because such firms have legitimate market risk exposure to changes in oil prices, the Exchange suggests that the Commission review this standard to assess whether it could be revised to address this problem.

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<sup>2</sup>See, e.g., CFTC v. Co Petro Marketing Group, 680 Fd 2nd 573 (9th Cir. 1982).

<sup>3</sup>In the Federal Register release, the CFTC suggested that Congress did not intend that such a determination must be made prior to the exercise of exemptive authority under Section 4(c). ¶ 25,539, p. 39,589, n. 13. Comm. Fut. L. Repr. (1992-1994 Transfer Binder).

<sup>4</sup>Under Section 9(a)(5) of the Act, willful violation of any other provision of the Act is a felony.

**31. Should the Commission establish a class of eligible participants for the trading of hybrid instruments with a predominant commodity-dependent component? If so, please describe.**

While the Exchange favors use of a single definition of sophisticated investor, it also believes that hybrid instruments with a predominant commodity-dependent component have the potential to be structured so as to be essentially equivalent to exchange-traded contracts. Therefore, NYMEX believes that further study is warranted before any change should be considered in this area.

**32. Is it advisable to use a single definition of sophisticated investor whenever that concept arises under the Commission's regulations? If so, what definition should apply?**

Yes. The Commission should use a single definition of sophisticated investor whenever that concept arises under the Commission's regulations. This regulatory change would remove unnecessary regulatory burden and would improve regulatory compliance. The Exchange believes that the Commission should undertake a careful review of the numerous definitions currently in use in its regulations and issue proposed changes for public comment.

**Clearing**

**33. Are any swaps currently subject to any type of clearing function, either in the U.S. or abroad? If so, please provide details.**

According to published reports, Brazil's commodities and futures exchange, Bolsa de Mercadorias & Futuros ("BM&F") electronically clears swaps contracts on that exchange, but only those swaps traded on that exchange. In addition, the International Petroleum Exchange (IPE) in London clears exchanges of futures for swaps ("EFS"). In addition, CFTC staff previously approved the use of EFS procedures for the Finex Division of the New York Cotton Exchange.

**34. Would permitting swap clearing facilities promote market growth and assist U.S. participants in remaining competitive? If so, please describe the appropriate elements of a program for the oversight of swap clearing organizations.**

The Exchange believes that swaps clearing facilities will provide significant benefits to participants using such a facility, including allowing such participants to reduce the degree of counterparty credit risk in their swaps books. Thus, permitting swap clearing facilities may well promote market growth and assist U.S. participants in remaining competitive. The appropriate elements of a program for the oversight of swap clearing organizations and the answers to

questions #36-40 are discussed in detail in Section III. A. of the attached comment letter.

**35. Should there be a limit on the clearing functions permitted for swaps?**

With regard for example to OTC derivatives clearing facilities, the CFTC noted in the OTC Concept Release that such facilities could perform a variety of functions ranging from simple trade comparison and recordation to netting of obligations to the guarantee of performance. The Commission also noted that, in jurisdictions other than the U.S., there may not be a clearing guarantee, or the guarantee may attach at a time other than the initiation of the trade. NYMEX does not believe that it is necessary for the CFTC to limit the functions of a OTC derivatives clearing facility or to restrict the timing of when a transaction would need to be posted on the clearing facility. In other words, whether or not the Commission should approve a particular OTC derivatives clearing facility proposal should not turn on whether or not the facility includes a guarantee of performance, but rather on whether the proposal appropriately addresses all associated financial risks for such a guarantee.

**Transaction Execution Facilities**

**41. Should the definition of MTEF be changed in any way to provide more clarity?**

In the release issuing Part 35, the Commission described an MTEF as: “[a] physical or electronic facility in which all market makers and other participants that are members simultaneously 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.” 58 FR 5587 at 5591 (January 22, 1993). At this time, the Exchange does not believe that it is necessary for the CFTC to modify this definition.

**42. Are MTEFs or other types of execution facilities currently being used for swap trading, either in the U.S. or abroad? If so, please provide details.**

As noted above, swaps are traded on the BM&F. According to press reports, the BM&F commenced trading in swaps contracts in 1997. More generally, on the global level, there appears to be a trend in the direction of increasing acceptance and use of electronic execution facilities, which may extend to use of MTEFs to trade swaps. In this regard, the Exchange notes that the petition for exemptive relief pursuant to Section 4(c) of the Act, which was submitted by the London Clearing House Limited (“LCH”) by letter dated June 15, 1998, referred to two swaps matching systems, Accord and Londex. The LCH’s petition indicates that these swaps matching systems involve the confirmation of transactions; it is

unclear from this petition whether these systems also may involve aspects of trade execution as well.

**43. What terms and conditions, if any, should be applied to execution facilities? Please address potential competitive effects on current exchange trading and the degree to which similar requirements should be made applicable. Please also address the strengths and weaknesses of current Part 36 for this purpose.**

MTEFs generally would involve the use of standardized instruments; in addition, as any member of the facility has the capability to bind any other member in a particular transaction, the creditworthiness of a particular counterparty would no longer appear to be a material consideration in that transaction. NYMEX believes strongly that, as discussed more fully in the attached comment letter, the trading of swaps on MTEFs renders such instruments indistinguishable from futures contracts traded on regulated futures exchanges and thus such transactions should be subject to the same regulation imposed upon transactions executed at futures exchanges.

#### **Registration**

In response to questions #44-47, NYMEX opposes the imposition of any registration requirement by the CFTC on persons and entities involved in exempted OTC derivatives transactions.

#### **Capital**

In answer to questions #48-50, NYMEX believes, with one exception, that it is not necessary for the Commission to establish capital requirements for participants in the OTC derivatives markets. However, in the event that the CFTC should ever permit appropriately designed and regulated swaps clearing facilities to commence operation, clearing members of any such facilities should be required to comply with appropriate capital and other requirements.

#### **Internal Controls**

In response to questions #51-55, the Exchange observes that, as part of prudent corporate practice, OTC derivatives market participants already utilize internal control guidelines, and such guidelines are best determined by such participants consistent with their other internal control procedures. In this regard, NYMEX notes that, as part of its application process for hedge exemptions from speculative position limits, the Exchange requires applicants to provide information on the overall system of internal controls used in the applicant's risk management programs, which includes the applicant's internal control

procedures relating to swap exposures. Such information should include a description of the policies and procedures for the evaluation and supervision of the applicant's risk management programs, including the use of "stress-testing" for periods of price volatility. The application also should specify the frequency with which such supervision is conducted. Accordingly, NYMEX believes that it is not necessary for the CFTC to mandate its own specific internal control guidelines.

### **Sales Practices**

In response to questions #56-68, NYMEX believes that the sophisticated firms and individuals qualifying as eligible swap participants under Part 35 have or should be deemed to have the wherewithal to negotiate and obtain, in their swap agreements, any disclosures sought from their counterparties and to pursue vigorously any perceived contract law claims relating to such swaps agreements. Therefore, NYMEX does not believe that there is a need for significant regulation of the sales practices of eligible swap participants entering into exempted transactions with each other.

### **Recordkeeping**

**69. Are recordkeeping requirements for participants in the OTC derivatives markets needed? If so, what records should be required? Who should be required to keep them?**

The Exchange believes that CFTC recordkeeping requirements for participants in the OTC derivatives markets are not needed and notes instead that maintenance of records of financial transactions is generally required under state law.

### **Reporting**

**70. Should the Commission establish reporting requirements for participants in the OTC derivatives markets? If so, what information should be reported? By whom?**

NYMEX believes, with one exception, that it is not necessary for the Commission to establish reporting requirements for participants in the OTC derivatives markets. However, in the event that the CFTC should ever permit appropriately designed and regulated swaps clearing facilities to commence operation, clearing members of any such facilities should be required to comply with appropriate reporting requirements.

**Self-Regulation**

In the OTC Concept Release, the Commission also sought the views of commenters "concerning whether, and to what extent, any needed changes concerning the oversight of the OTC derivatives market could be accomplished through initiatives of industry bodies either voluntarily or through a self-regulatory organization empowered to establish rules and subject to Commission oversight." Questions #71-75 address several aspects of self-regulatory efforts in the OTC derivatives market. NYMEX views these questions as being directed to participants in the swaps market, and accordingly the Exchange refrains from commenting upon these questions.