

The Chase Manhattan Bank  
270 Park Avenue, 40th Floor  
New York, NY 10017-2070

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Marjorie E. Gross  
Senior Vice President  
Associate General Counsel  
Legal Department

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## COMMENT

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OFFICE OF THE SECRETARIAT

October 13, 1998

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: Over-the-Counter Derivatives Concept Release

Ladies and Gentlemen:

The Chase Manhattan Bank ("Chase") appreciates the opportunity to comment on the Concept Release on Over-the-Counter Derivatives (the "Concept Release") issued by the Commodity Futures Trading Commission (the "CFTC") on May 12, 1998 (63 Fed. Reg. 26114). Although the Concept Release asks a large number of questions on the swaps market and the hybrid instruments market, Chase would like to comment only on a few broad issues. Chase is also a member of the International Swaps and Derivatives Association and the FX Committee, and supports the comment letters of those groups.

### 1. Legal Certainty.

Chase believes that the Concept Release may potentially create uncertainty in a key sector of the financial markets that could be easily avoided by a more systematic approach to the issues by the President's Working Group. The market for over-the-counter derivatives ("OTC Derivatives") has not changed fundamentally since the CFTC adopted its Swap Exemption in 1993. Although the number of OTC Derivative products and the volume of trading in OTC Derivatives have both increased, the basic nature of both the products and the markets are the same. OTC Derivatives have not become more standardized. They remain products that are individually tailored to the needs of the customer and that are individually negotiated. Thus there is no reason to question the fundamental conclusion of the Futures Trading Practices Act of 1992 that swaps are not futures and should not be regulated in the same way as futures.

As the CFTC notes in the Concept Release, growth in the OTC Derivatives market might be accomplished by increasing legal certainty. Conversely, severe detriment to the market may be created by questioning the enforceability of OTC Derivatives. Chase is a large dealer in OTC Derivatives. Consequently, managing legal

risk in our portfolios is a matter of great importance to us. In our opinion, the Concept Release increases our legal risk.

A basic assumption of Chase's exposure systems is that our legal agreements with our counterparties are enforceable. Unfortunately, the regulatory scheme under the Commodities Exchange Act is such that, if a transaction is a "future" that is not exempt under the Act and is not traded on an exchange (i.e. is traded in the over-the-counter market), it is unenforceable. Chase has entered into numerous transactions involving OTC Derivatives on the assumption that they are not futures and may therefore be lawfully traded over-the-counter. Any suggestion in the Concept Release that these contracts are indeed futures transactions or may in the future be deemed to be futures raises the specter that our customers will attempt to deny liability under their contracts in which they are net payers.

The ability of parties to tailor OTC Derivatives to meet specific financial needs and the innovations in the OTC Derivatives market in recent years have contributed to making OTC Derivatives an indispensable tool for risk management as well as other financial purposes. This tool is used by a wide range of market participants, including financial institutions, other corporations, and governmental entities, to manage and hedge a wide range of risks. United States financial institutions have been in the forefront of the development of the OTC Derivatives market. This has contributed greatly to the growth, profitability, and soundness of the financial markets in the United States.

A key factor in the further development of the OTC Derivatives market in the United States is certainty as to the enforceability of the contractual obligations of the parties to OTC Derivative transactions. The introduction of any doubt as to such enforceability may stifle financial innovation and force large segments of the market offshore, to the detriment not only of domestic financial institutions but to all market participants and the economy as a whole. Clearly, this will not serve any beneficial purpose.

## 2. Swaps as Futures

Congress has never determined that a swap is a future and the CFTC has not previously taken a position on that issue. Chase believes that OTC Derivatives are not futures.

One of the most troubling aspects of the Concept Release is the suggestion that transactions that were not "futures" when entered into could become "futures" because of developments in the market. It is particularly alarming that the CFTC believes that certain types of transaction are so common that they meet the test for "standardized" contracts under the ESP exemption.

All our OTC Derivative transactions are individually negotiated. Most importantly, the parties negotiate the size, tenor and rate of each transaction. Unlike

exchange traded transactions, transaction size can be any number, down to the penny, and tenor can be any number of days. All other contractual terms of an OTC Derivative are also subject to negotiation by the parties. We make every effort to use the forms of master agreement developed by various industry groups (principally the ISDA Master Agreements for interest rate, currency exchange, commodity and credit transactions, and the FX Master Agreements - ICOM, IFEMA and FEOMA). However, each of our master agreements is subject to individual negotiation.

The Concept Release indicates that some swaps may be fungible because it is possible to obtain quotations from a large number of dealers. Chase fundamentally disagrees with this position. The fact that it is possible to obtain quotations from a large number of dealers is evidence of a liquid market. It is not evidence of fungibility. Each of these dealers will quote different economic terms, based on the creditworthiness of the counterparty, and the dealer's view of current rates or prices.

### 3. Netting

The Concept Release refers to the benefits of netting. The recognition by the Bank for International Settlements and the U.S. banking regulators of the benefits of close-out netting has been an important factor in our ability to continue providing risk management products to our customers. Chase now calculates its exposure to counterparties on a net basis in a large number of jurisdictions, based on legal opinions obtained in each of those jurisdictions. However, a basic assumption in those netting opinions is that the underlying contracts are enforceable under the law by which they are governed. Over half of our contracts are governed by New York law and would thus be affected by a determination that they involve illegal futures contracts.<sup>1</sup> Any action by the CFTC that calls into question our basic enforceability assumption has serious consequences that is likely to impair the growth of the market in this country.

### 4. Clearing

The Concept Release views clearing as tantamount to exchange trading. Although Chase has not participated in any efforts to develop clearing mechanisms for derivatives transactions, we have participated in a number of efforts to develop clearing mechanisms for foreign exchange. Indeed, such efforts are being strongly encouraged by our banking regulators. See, e.g. Bank for International Settlements, *Settlement Risk in Foreign Exchange Transactions* (March 1966). And recent progress on the netting front has been applauded by those regulators. Bank for International Settlements, *Reducing Foreign Exchange Settlement Risk: A Progress Report* (July 1998).

We believe there is no justification for the CFTC to attempt to exert jurisdiction over the clearing and settlement of foreign exchange products. The so-called Treasury

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<sup>1</sup> Some portion of these are with non-U.S. counterparties and the business could be shifted offshore.

Amendment to the Commodity Exchange Act specifically excludes jurisdiction over foreign exchange unless it is conducted on a "board of trade". As we noted in our testimony before the House Committee on Banking and Financial Services (July 17, 1998), the CFTC's assertions of jurisdiction in this area has affected the availability of risk-reducing facilities to U.S. participants.

\* \* \* \*

The threat posed by the Concept Release to the legal certainty of OTC Derivatives transactions and the further development of OTC Derivatives instruments and systems for reducing risk in the clearing and settlement of such instruments far outweighs any benefit to be accrued from the CFTC's fact finding efforts. Consequently, Chase joins the Federal Reserve Board, the Treasury Department, the Securities and Exchange Commission, and a wide range of market participants in requesting that the CFTC abandon any efforts to revisit current regulations governing OTC Derivatives on its own and cooperate with all interested parties in discussing the proper framework for legal certainty for such vital transactions that will ensure their continued development and contribution to the economy.

Very truly yours,

Marjorie E. Gross  
Senior Vice President  
& Associate General Counsel