

NEW YORK CLEARING HOUSE

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COMMENT

October 13, 1998

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: Concept Release on
Over-the-Counter Derivatives

Dear Ms. Webb:

This letter is submitted on behalf of the member banks of The New York Clearing House Association L.L.C.* in connection with the Concept Release on Over-the-Counter Derivatives ("Concept Release") issued by the Commodity Futures Trading Commission (the "Commission"), 63 Fed. Reg. 26,114 (May 12, 1998). The member banks of the New York Clearing House are concerned that the issuance of the Concept Release, and any actions taken by the Commission to implement the types of regulation contemplated by the Concept Release, will serve only to foster uncertainty with respect to the enforceability and legal status of a wide variety of important financial transactions. This in turn will undermine U.S. financial markets, force such markets to operate outside the United States and deprive U.S. entities of the benefits of participation in such markets, to the detriment of the U.S. financial markets and its economy.

Many types of over-the-counter derivatives, such as swaps and certain categories of options, have never been found to constitute futures contracts or commodity options that are within the jurisdiction of the Commodity Exchange Act ("CEA") and the

* The member banks of the Clearing House are: The Bank of New York, The Chase Manhattan Bank, Citibank, N.A., Morgan Guaranty Trust Company of New York, Bankers Trust Company, Marine Midland Bank, Fleet Bank N.A., European American Bank and Republic National Bank of New York.

Commission. In our view, most over-the-counter derivatives either do not constitute futures contracts or commodity options or are excluded from regulation under the CEA pursuant to the "forward contract exclusion", the "Treasury Amendment" or other provisions of the statute. Nevertheless, transactions that are found to constitute futures contracts or commodity options may be illegal and unenforceable and, to the extent that over-the-counter derivatives are so characterized, counterparties to such transactions might be able to avoid their obligations. In view of these potential consequences, Congress granted the Commission exemptive authority with respect to over-the-counter derivatives (as well as other instruments), through the adoption of the Futures Trading Practices Act of 1992, for the express purpose of providing greater legal certainty regarding their status under the CEA:

In granting exemptive authority to the Commission under new section 4(c), the Conferees recognize the need to create legal certainty for a number of existing categories of instruments which trade today outside the forum of a designated contract market. These instruments may contain some features similar to those of regulated exchange-traded products but are sufficiently different in their purpose, function, design, or other characteristics that, as a matter of policy, traditional futures regulation and the limitation to the floor of an exchange may be unnecessary to protect the public interest and may create an inappropriate burden on commerce.

H.R. Rep. 978, 102d Cong., 2d Sess. 80 (1992).

It is significant to note that Congress expressly declined to provide the Commission with the authority to regulate swaps and other types of over-the-counter derivatives, noting that "as a matter of policy, traditional futures regulation" of such instruments was not warranted. Instead, Congress granted the Commission exemptive authority for the purpose of avoiding regulation of the derivatives markets by the Commission and directed the Commission to use this authority to exempt -- not regulate -- the over-the-counter derivatives market: "In this respect, the Conferees expect and strongly encourage the Commission to use its new exemptive powers promptly upon enactment of the legislation in four areas where significant concerns of legal uncertainty have arisen: (1) hybrids, (2) swaps, (3) forwards, and (4) bank deposits and accounts". *Id.* At 81.

Moreover, in order to avoid any implication that instruments covered by Commission exemptions would otherwise be subject to the CEA, Congress made it clear that, in exercising its exemptive authority, the Commission was not required to make any determination as to whether such instruments are futures contracts or commodity options:

The Conferees do not intend that the exercise of exemptive authority by the Commission would require any determination beforehand that the agreement, instrument or transaction for which an exemption is sought is subject to the Act [the CEA]. Rather, this provision provides flexibility for the Commission to provide legal certainty to novel instruments where the determination as to jurisdiction is not straightforward. Rather than making a finding as to whether a product is or is not a futures contract, the Commission in appropriate cases may proceed directly to issuing an exemption.

Id. at 82-83. On this basis, the Commission, in adopting the exemption for swap agreements set forth in Part 35 of its regulations, stated that "[t]he issuance of this rule should not be construed as reflecting any determination that the swap agreements covered by the terms hereof are subject to the Act, as the Commission has not made and is not obligated to make any such determination". Exemption for Certain Swap Agreements, 58 Fed. Reg. 5587, 5588 (Jan. 22, 1993).

The Concept Release does not expressly address the status of over-the-counter derivatives under the CEA. However, because the Commission has no jurisdiction over such instruments unless they constitute futures contracts or commodity options, the fact that the Commission has issued the Concept Release could create confusion, and foster legal uncertainty, as to whether certain types of over-the-counter derivatives constitute futures contracts or commodity options. As a result, the Concept Release could be construed as a dramatic departure from the prior position of the Commission and from the intent of Congress in granting the Commission exemptive authority in 1992.

This, in our view, is likely to foster the type of legal uncertainty that Congress and the Commission sought to eliminate through the adoption of exemptive authority and exemptive regulations. In particular, certain types of swaps might not be eligible for the exemption afforded by Part 35 of the Commission's rules and the enforceability of such instruments could be called into question by the Commission's assertion of jurisdiction in this area. Moreover, the issuance of the Concept Release and

the Commission's consideration of changes in the current regulatory regime indicate that even those instruments eligible for the Part 35 exemption might be considered futures contracts or commodity options and, depending on the scope and nature of the changes made to that exemption, could be subject to challenge on enforceability grounds as well.

These results, we believe, will force many financial institutions to conduct their over-the-counter derivatives businesses and operations outside the United States, thereby undermining the competitiveness of the U.S. financial services industry. This will bring about precisely the result Congress was attempting to avoid by granting the Commission exemptive authority in 1992. In fact, at the time of its adoption of that legislation, Congress noted that "[m]any markets of this nature are international in scope; foreign parties are already engaging in such transactions free of restraints imposed by the Act that may create competitive disadvantages for U.S. participants".* H.R. Rep. 978, 102d Cong., 2d Sess. 82 (1992). Moreover, and potentially of even greater significance, the legal uncertainty created by the Concept Release could make financial institutions reluctant or unwilling to enter into derivatives transactions with U.S. counterparties. This in turn will make it more costly, less efficient and, in some cases, impossible for businesses to engage in necessary hedging and risk management activities, with significant adverse consequences for the U.S. economy. The U.S. legislative and regulatory efforts undertaken to date with respect to over-the-counter derivatives, under the CEA as well as other legal and regulatory regimes, have been primarily intended to reduce legal and systemic risk, provide greater legal certainty and enhance the ability of market users to engage in necessary hedging and risk management transactions. The issuance of the Concept Release, and any further action taken by the Commission to implement the types of regulation discussed in the Release, will have the opposite effect and will negate much of that effort.

We also do not believe that additional regulation of the over-the-counter derivatives markets, of the type contemplated by the Concept Release, is warranted. The well-publicized events involving derivatives that are cited by the Commission represent instances in which specific, isolated problems arose that were adequately addressed, if necessary, under existing law and regulation. There is no indication — and the Commission offers no support for the proposition — that Commission regulation of the derivatives markets will reduce or eliminate the perceived problems that the Commission has identified. We also do not believe that such regulation will provide public protection

* Although this statement was made in the context of a discussion of forward contracts, rather than swaps or options, it is clearly equally applicable to all types of over-the-counter derivatives.

benefits that outweigh their likely adverse effect on the financial markets and the U.S. economy. In this regard, we note that dealers and end-users in the over-the-counter derivative markets are typically sophisticated institutional entities, many of which are regulated by bank regulatory authorities, the Securities and Exchange Commission or other regulators. In view of these considerations, we believe that Commission regulation will serve only to increase the cost and reduce the efficiency of over-the-counter derivatives transactions, and to make such transactions unavailable to certain market participants.

The member banks of the New York Clearing House appreciate this opportunity to express our views on the Concept Release and of course stand ready to provide any further assistance that may be necessary or helpful to the Commission in its consideration of these issues.

Very truly yours,

A handwritten signature in cursive script that reads "Jill M Amadio". The signature is written in black ink and is positioned below the typed name "Jill M Amadio".