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August 31, 2000

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OFFICE OF THE SECRETARIAT

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

Re: Proposed Parts 35, 36, 37, 38 and 39 of the Commission's Rules: *Exemption for Bilateral Transactions*, *Regulatory Reinvention* and *Clearing Organizations Reinvention*

Dear Ms. Webb:

We are submitting this letter on behalf of our clients, a coalition of the commercial and investment banks named below (the "Coalition"), in response to the Commodity Futures Trading Commission's (the "Commission") releases published June 22, 2000 (the "Releases"), proposing a revised Part 35 *Exemption for Bilateral Transactions*, new Parts 36, 37 and 38, *A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations*, and new Part 39, *A New Regulatory Framework for Clearing Organizations* (collectively, the "Proposed Rules").

The Coalition consists of the following financial institutions:

The Chase Manhattan Bank
Citigroup Inc.
Credit Suisse First Boston Inc.
Goldman Sachs & Co.
Merrill Lynch & Co., Inc.
Morgan Stanley Dean Witter & Co.

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The Coalition appreciates the opportunity to comment on this important rulemaking initiative by the Commission. The six Coalition firms are major participants in the U.S. and foreign financial markets, including the securities markets, government securities markets, foreign currency markets, futures markets and derivatives markets. These firms are in the forefront of financial product innovation and compete globally with non-U.S. financial institutions for international business in U.S. and foreign financial markets.

The Coalition endorses the efforts of the Commission and its staff to review and update the regulatory framework established under the Commodity Exchange Act (the "CEA") in light of developments affecting the over-the-counter and listed derivatives markets in the United States and abroad. The Coalition believes that it is essential that the Commission take unambiguous steps to promote legal certainty and ensure that the United States remains a hospitable jurisdiction for market innovation. The Commission's participation in formulating the unanimous recommendations contained in the 1999 report of the President's Working Group on Financial Markets, *Over-the-Counter Derivatives Markets and the Commodity Exchange Act* (the "President's Working Group Report") was an extremely important and constructive step in accomplishing these goals.

The Coalition believes that legislation implementing the recommendations of the President's Working Group Report and related measures is important and, indeed, essential to the accomplishment of certain of these objectives.[1] The uncertainty of the legislative process, however, makes the Commission's initiative an important alternative vehicle for accomplishing these objectives.

The Proposed Rules, and the Releases generally, if adopted, would clearly further the objectives of the President's Working Group Report. In particular, the proposed framework would significantly enhance legal certainty for over-the-counter ("OTC") derivatives and promote the use of clearing facilities and electronic execution facilities for OTC derivatives. In this regard, the proposed framework would eliminate many existing obstacles to innovation in U.S. derivatives markets and advance the position of the United States as a leading international financial center. The Coalition commends the Commission for proposing these measures.

The Proposed Rules would also unbundle the regulation of trading facilities and clearing facilities and would establish a tiered approach to the regulation of trading facilities, based on the scope of permitted participants and the extent of the manipulation risk presented by the specific commodities underlying transactions on the facility. The Coalition supports the Commission's efforts to modernize the CEA's regulatory framework in a manner consistent with the public interest and the maintenance of efficient and competitive markets.

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1 More specifically, the Coalition believes that legislative action is essential in the context of regulatory activities affected by the CEA's exclusive jurisdiction provisions and in the context of market activities involving futures on non-exempt securities. Legislation may also be important in order to derive the full benefits of the Commission's desire to provide voluntary regulatory frameworks for clearing, independent of the operation of a contract market, and the electronic trading of derivatives that are not commodity futures or options contracts.

The Coalition thus supports adoption of final rules as expeditiously as possible, subject to the comments and recommendations set forth below, which the Coalition believes will enhance the Proposed Rules in a manner consistent with the recommendations of the President's Working Group Report.

The following discussion focuses on the Coalition's suggestions with respect to (i) the revised Part 35 exemption for bilateral transactions, (ii) the proposed Part 36 exemption for transactions on a multilateral transaction execution facility ("MTEF"), (iii) the proposed Part 37 exemption for derivatives transaction facilities ("DTEs") and (iv) the proposed Part 39 framework for the regulation of clearing organizations. Although the Coalition generally supports the extension of regulatory relief to recognized futures exchanges ("RFEs") and the granting of corresponding relief for intermediaries, the Coalition does not intend to comment specifically on the provisions of the Proposed Rules relating to these issues.

In addition to the recommendations discussed below relating specifically to the Proposed Rules, the Coalition has included recommendations for additional action by the Commission in connection with the Commission's final rulemaking. These additional measures include clarifications to the Commission's Policy Statement Concerning Swap Transactions (the "Swap Policy Statement") and the Commission's Statutory Interpretation Concerning Hybrid Instruments (the "Hybrid Interpretation") and the issuance of interpretative or exemptive relief, in consultation with the Department of the Treasury, to provide greater clarity with respect to the scope of the so-called "Treasury Amendment," CEA Section 2(a)(1)(A)(ii). The Coalition believes that these additional measures are essential if the Commission is to provide effective and comprehensive administrative relief to redress legal certainty concerns consistent with the recommendations of the President's Working Group Report.

I. Part 35 Exemption for Bilateral Transactions.

A. General Comments.

The proposed revisions to the Commission's existing Part 35 swap exemption (the "Existing Swap Exemption") would eliminate various provisions that give rise to significant uncertainties as to the scope of the exemption and would promote innovation in the OTC derivatives markets. In particular, revised Part 35 would:

- eliminate uncertainty as to the scope of the "swap agreement" definition;
- eliminate uncertainty as to the meaning of the requirement that a covered transaction not be part of a fungible class of agreements that are standardized as to their material economic terms;
- promote the use of clearing facilities for OTC derivatives and contribute to a reduction in systemic credit risk; and

- promote the use of electronic technology, other than electronic trading facilities, in connection with OTC derivatives and contribute to improvements in efficiency and the reduction of settlement risk.

The Coalition strongly endorses these rule proposals. The Coalition believes that the uncertainty that has arisen over the years regarding the scope of the swap agreement definition and the non-fungibility requirement has been deleterious for the market and was not consistent with the original intent underlying the affected provisions. Accordingly, the proposed changes are important both in clarifying the original intent of the Existing Swap Exemption and in recalibrating the exemption in a manner consistent with the evolution of activity in OTC derivatives.

The significant scope of activity in OTC derivatives and the remarkably few misadventures that have occurred over the past decade are strong corroboration of the Commission's implicit judgment that this activity has evolved in a manner that does not require and would not benefit from substantive federal regulation under the CEA, independent of the underlying jurisdictional issues.

In addition, revised Part 35 would include provisions limiting the ability of an eligible participant to repudiate unprofitable contracts based on the CEA. These provisions would significantly enhance the legal certainty of OTC derivatives transactions, including those entered into in reliance on the Swap Policy Statement and Hybrid Interpretation.

The provisions precluding contract repudiation based on an allegation that a transaction complying with the Swap Policy Statement or Hybrid Interpretation nonetheless violates the CEA or Commission rules, in particular, represent a thoughtful and creative approach to reducing existing legal uncertainty under the CEA in an area in which the Commission's exemptive authority under Section 4(c) of the CEA is significantly constrained. These provisions are particularly important in the context of transactions involving non-exempt securities, the category of OTC derivatives transactions that is in greatest need of enhanced legal certainty.

Taken together, these provisions would also significantly reduce the systemic credit implications of legal uncertainty affecting the covered products. The Coalition thus strongly endorses the inclusion of these provisions in proposed Rule 35.3(b) and (c) as central to the Commission's legal certainty initiative.

B. Recommendations.

The Coalition has set forth in the following sections recommendations designed to enhance proposed revised Part 35 in a manner consistent with the goals articulated by the Commission in the Releases.

1. Proposed Rule Modifications

a. "Creditworthiness" Requirement.

The revised Part 35 exemption would require that, if a transaction is not submitted for clearing, the creditworthiness of the counterparty must be a material consideration in entering into the transaction. The Coalition believes that this requirement is unnecessary and may well lead to confusion and uncertainty. The Coalition recommends that the Commission adopt, instead, the approach to this issue proposed by the Commission in revised Part 36.

More specifically, the creditworthiness requirement in the Existing Swap Exemption was intended to preclude the use of clearing organizations for the clearance and settlement of swap transactions.[2] In light of the Commission's determination to permit clearing of exempt transactions in circumstances where the clearing organization is subject to appropriate regulatory oversight, the Coalition believes that this provision should be amended accordingly to provide that if a transaction is submitted for clearance and settlement to a clearing organization, the clearing organization must be authorized under Part 39. This is the approach proposed by the Commission under Part 36.

The approach proposed by the Commission in revised Part 35, however, would create uncertainty by suggesting that the creditworthiness requirement means more than that the underlying transaction is not subject to multilateral clearance and settlement arrangements. This may create uncertainty regarding, and have a chilling effect on, the use of alternate forms of bilateral credit enhancement. This result would be highly undesirable in a market in which credit intermediation by individual intermediaries is an important function. Accordingly, the Coalition strongly recommends that the Commission conform its approach to this issue in Part 35 to the approach proposed by the Commission in Part 36.

b. Principal vs. Agency Transactions.

As drafted, revised Part 35 is unclear as to whether transactions effected by an eligible participant on behalf of another eligible participant would be eligible for exemption. The definitions of certain types of eligible participants, such as banks, broker-dealers and futures commission merchants ("FCMs"), refer expressly to parties acting as principal or agent, whereas other definitions are silent. The Coalition believes that a preferable approach would be to remove references to principal or agency transactions from the definitions of the various classes of eligible participants and provide in the operative provisions of the rule that the exemption would be available to eligible participants trading for their own account *or through another eligible participant*, as under proposed Rule 36.2(a). Any limitations on the scope of such agency relationships should be specifically identified.

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[2] See Exemption for Certain Swap Agreements, 57 Fed. Reg. 53627, 53629 (Nov. 12, 1992) (proposing release).

c. Definition of Eligible Participant.

The Coalition believes that, in light of the Commission's favorable experience with the Existing Swap Exemption, the categories of eligible participants under proposed Rule 35.1(b) should be expanded in the following ways:

- Banks. In addition to banks and trust companies, this category of eligible participants should expressly include foreign banks and branches or agencies of foreign banks (as defined in Section 1(b) of the International Banking Act of 1978), so-called "Edge Act corporations," federal and state credit unions, institutions regulated by the Farm Credit Administration, so-called "agreement corporations," financial holding companies (as defined in Section 2 of the Bank Holding Company Act of 1956) and similarly regulated affiliates of the foregoing.

- Insurance companies. Regulated subsidiaries and affiliates of state- or foreign-regulated insurance companies should be eligible participants.

- Broker-dealers. Material associated persons of registered broker-dealers for which the broker-dealer makes and keeps records under Sections 15C(b) or 17(h) of the Securities Exchange Act of 1934 and investment bank holding companies (as defined in Section 17(i) of the Securities Exchange Act of 1934) should qualify as eligible participants.

- FCMs. Affiliated persons of registered FCMs for which the FCM makes and keeps records under Section 4f(c)(2)(B) of the CEA should be eligible participants.

- Natural Persons. The definition of eligible participant should be expanded to include, in addition to natural persons with total assets exceeding $10 million, natural persons who have total assets exceeding $5 million and who enter into the transaction in order to manage the risk associated with an asset or liability owned or incurred or reasonably expected to be owned or incurred by such person.

Many derivatives activities of financial institutions are conducted by or through the additional types of entities referred to above. Although certain of these entities would fall into the general corporation category in proposed Rule 35.1(b)(6), the Coalition believes it would be preferable to treat these entities as separate categories of eligible participant without regard to the asset and other requirements for corporate eligible participants.

With respect to natural persons, the Coalition is not aware of any abuses that have arisen in connection with the $10 million asset standard for natural persons under the Existing Swap Exemption and believes that it would be appropriate to provide legal certainty for OTC derivative transactions for a somewhat broader group of individuals with significant assets who

enter into the relevant transaction for risk management purposes. The Coalition notes in this regard that a similar distinction is drawn in the context of business corporations, which entities must have $10 million in total assets unless they enter into the relevant transaction for hedging or other business requirements, in which case they need only have $1 million in net worth.

d. Definition of MTEF.

The Coalition believes that the revised definition of MTEF in proposed Part 36, while providing significantly greater clarity than the explanation of that term contained in the preamble to the Existing Swap Exemption, is arguably narrower in one significant respect. Because the definition refers to facilities on which bids and offers are open to *multiple* participants, rather than *all* participants, as under the existing definition, the new MTEF definition might, for the first time, encompass electronic systems that incorporate the ability to filter bids, offers or acceptances based on the existence and extent of mutual extensions of credit between the counterparties or prospective counterparties. Accordingly, transactions conducted on such systems could be ineligible for the Part 35 exemption.

This is the only respect in which the proposed revisions to Part 35 *narrow* rather than clarify or broaden the Existing Swap Exemption.

The principal feature of such credit-screened systems is that transactions can be executed only between parties who have individually negotiated the credit and other material terms of their relationship and who have made individual credit determinations based on knowledge of their potential counterparties. This type of credit determination is typical of swap transactions eligible for the Existing Swap Exemption and the proposed revised Part 35 exemption.

Credit screened systems are also generally limited to professional and other regular participants in the relevant market. The Coalition sees no compelling policy reason to preclude participants in such credit-screened systems from transacting through those systems contracts involving the full range of commodities acceptable under revised Part 35, as opposed to the significantly narrower range available under new Part 36. The Coalition accordingly believes that credit-screened transactions should remain eligible for the Part 35 exemption and requests that the MTEF definition be revised by adding the following subsection at the end of Rule 36.1(b):

"(4) any facility:

(i) whose participants individually negotiate (or have individually negotiated) with counterparties the material credit terms applicable to transactions between them, including transactions conducted on the facility; and

(ii) either (A) that incorporates credit screens or filters that prevent any participant from executing a transaction with another participant unless both participants have approved the extension of credit to the other prior to entering into the transaction or (B) on which matched

bids and offers are not binding, but are subject to subsequent acceptance by the counterparties based on counterparty credit considerations."

In the event that the Commission is concerned about unintended expansions in the scope of the permitted systems proposed to be excluded by the language suggested immediately above, the Coalition would be pleased to work with the Commission and its staff to address those concerns with greater specificity.

e. Netting.

The explicit authorization for netting arrangements should apply to netting of *deliveries* and *delivery obligations* as well as netting of payments and payment obligations.

f. Additional Conforming Recommendation.

The Coalition also recommends that Proposed Rule 35.1(a) be amended to replace the reference to "swap agreement" with "agreement, contract or transaction".

2. Recommended Revisions to the Preamble to Revised Part 35.

- The Commission should clarify in the preamble to the final rules that the criterion set forth in Proposed Rule 35.2(a) is satisfied by a party in circumstances where the party reasonably believes, at the time the relevant agreement, contract or transaction is executed, that its counterparty is an eligible participant.

- In the first paragraph of Section II,[3] the Coalition recommends that the Commission clarify that the replacement of references to "swap agreements" with references to "contracts, agreements or transactions" is not intended to suggest any expansion of the Commission's jurisdiction, but is instead intended to clarify that the new exemptions are applicable to any contract, agreement or transaction that is a futures contract or commodity option, without regard to any further qualification.

- In addition, the Coalition recommends that the Commission modify the discussion in the first paragraph of Section II of the exemption from the CEA's private right of action to clarify that a transaction would not be void, voidable, unenforceable or subject to rescission solely due to a violation of the exemption's requirements. (Proposed additional language is underlined.)

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3 65 Fed Reg. 39033, 39034 (June 22, 2000).

- The definition of MTEF in the preamble should be conformed to the definition in the Proposed Rules. In addition, the discussion of exclusions from the definition should be modified to clarify that facilities merely used as a means of communicating bids, offers or acceptances thereof would not be included in the definition. (Proposed additional language is underlined.)

- The preamble to the final rule should state that references to "bilateral" transactions in the heading of proposed Part 35 and the Releases are not intended to import any requirement additional to the those expressly set forth in proposed Rule 35.2, but is intended rather to distinguish Part 35-exempt transactions from transactions conducted on an MTEF.

- The Coalition recommends that the Commission expand its Section 4(c) findings by reciting that the Part 35 amendments will promote financial innovation and reduce systemic risk, *inter alia*, by permitting expanded use of electronic communication facilities and clearing arrangements.

II. Part 36 Exemption for Transactions on an MTEF.

A. General Comments.

The proposed Part 36 exemption addresses a key limitation of the Existing Swap Exemption, which does not apply to transactions executed on or through an MTEF. The Coalition strongly supports the Commission's proposal, and believes that the proposal represents a very important initiative both to promote legal certainty and to facilitate the development by U.S. market participants of electronic trading systems and technologies and the expanded use of clearing facilities.

In addition, proposed Part 36 would also include provisions similar to those in revised Part 35 limiting the ability of an eligible participant to repudiate unprofitable contracts based on the CEA. The Coalition strongly supports these provisions for the reasons discussed above.

The Coalition nevertheless recommends that the scope of the proposed Part 36 exemption be expanded in certain respects. The Coalition believes that these recommendations can be implemented by the Commission without giving rise to additional regulatory concerns and would significantly enhance the efficacy of proposed Part 36. The Coalition's specific recommendations are set forth below.

B. Recommendations.

1. Permissible Underlying Commodities.

The range of permissible underlying commodities for transactions eligible to be traded on an MTEF should be modified in the following respects:

- Macroeconomic indices and measures, in addition to indices or measures of inflation, should expressly be included. Indices of this type are financial in nature and do not present a significant risk of manipulation.

- Transactions involving intangible commodities not susceptible to a significant risk of manipulation, such as telecommunications minutes or bandwidth, should also be eligible for the exemption.

- Clause (7) of proposed Rule 36.2(b) should be clarified to read as follows: "an economic or commercial rate, differential, index or measure (i) that is beyond the control of the parties to the transaction, (ii) that is not based upon prices derived from trading in a directly corresponding cash market, and (iii) for which the related contract, agreement or transaction is cash-settled."

Transactions involving these additional underlying commodities would generally not be subject to a materially greater risk of manipulation than those commodities expressly enumerated by the Commission in proposed Part 36. Accordingly, the Coalition believes that they are appropriate for an exempt MTEF under proposed Part 36 and do not require the additional regulation applicable to DTFs or RFEs.

In addition, the Coalition strongly recommends that the Commission add a provision that delegates to the Director of the Division of Economic Analysis the authority to designate additional commodities as eligible for Part 36-exempt transactions based on a determination that they are not subject to a significant risk of manipulation. The Coalition believes that a provision of this kind is important in order to maintain the vitality and efficacy of the Part 36 exemption as trading in new commodity classes develops. The delegation of this authority to qualified senior Commission staff will avoid potentially significant delays occasioned by a formal rulemaking process that are simply not justified by the nature of the determination to be made.

2. Definition of MTEF.

As described in the Coalition's comments with respect to Part 35 above, the Coalition believes that the definition of MTEF should expressly exclude electronic systems that incorporate credit screens that implement bilateral credit determinations and result in bilateral contractual relationships.

3. Availability of Part 36 for Transactions Involving Exempt Securities.

The Commission has requested comment as to whether the availability of the Part 36 exemption for transactions involving exempt securities, such as government securities, would "give rise to significant and undesirable opportunities for regulatory arbitrage." The Coalition does not believe that it is necessary or desirable to exclude transactions involving government securities and other exempt securities from the Part 36 exemption, and is strongly opposed to any such limitation.

It merits noting, as a threshold matter, that the vast majority of exempt securities are comprised of government securities. Transactions involving government securities are already excluded from the CEA to a significant extent pursuant to Section 2(a)(1)(A)(ii) of the CEA, the so-called "Treasury Amendment." To the extent such transactions are covered both by the proposed Part 36 exemption and the Treasury Amendment, no opportunity for regulatory arbitrage exists because the exclusive jurisdiction provisions of the CEA would not apply to the affected transactions. Accordingly, such transactions would be subject to regulation under the securities laws to the same extent as they would be absent any exemption under Part 36. Put differently, for this category of transaction, the proposed Part 36 exemption does not give rise to any new opportunity for regulatory arbitrage.

As the foregoing discussion demonstrates, however, uncertainty does exist as a result of the absence of a clearly understood interpretation of the scope of the Treasury Amendment. For this reason, among others, the Coalition strongly recommends that the Commission, in consultation with the Department of the Treasury and other members of the President's Working Group, issue an interpretation or exemption in conjunction with the Commission's final rulemaking, consistent with the recommendations of the President's Working Group Report, to provide greater clarity with respect to this issue. The Coalition would be pleased to assist the Commission and its staff in connection with any such initiative.

To the extent that any meaningful gap does exist between the scope of exempt securities transactions eligible for the Part 36 exemption and those eligible for the Treasury Amendment, intermediate steps exist to preclude abuses in these markets that do not necessitate that the relevant transactions be made ineligible for the Part 36 exemption.

Specifically, the Commission could require, in the context of any transaction involving the purchase or sale of an exempt security claiming the benefit of the Part 36 exemption, that any party to the exempt transaction that is acting in the capacity of a broker or dealer be registered as a government securities broker-dealer or a securities broker-dealer or be a bank subject to qualifying oversight. Such a measure would concomitantly avoid limitations on the Part 36 exemption that reduce the scope of the legal certainty benefits afforded by the proposed exemption while also providing substantial regulatory protections minimizing the regulatory risks alluded to by the Commission in its request for comment on this issue. The Coalition would again be pleased to assist the Commission and its staff in accomplishing these objectives.

4. Transparency.

Proposed Rule 36.2(g) would require that an MTEF disseminate certain types of market data if the Commission so requires after having determined that the MTEF performs a price discovery function. Specifically, the proposed rule provides that in such case "the facility must on a daily basis disseminate publicly trading volume and price ranges and other trading data appropriate to that market as specified in" the Commission's order.

Certain trading facilities, including, in particular, trading facilities limited to specific categories of professional or wholesale market participants, may perform a price discovery function *for the participants on the relevant facility* and not for end users or other persons who do not participate on the relevant facility. Tiered markets exist in almost every commercial market, with perhaps the sole exception of the equity markets. These markets often distinguish, for example, between producers, wholesale distributors and retail distributors, on the one hand, and wholesale or retail consumers, on the other hand. Concomitantly, participants in these market tiers often restrict price dissemination within the relevant market tier.

The Coalition recommends that the Commission clarify that proposed Rule 36.2(g) is not intended to be used by the Commission to require that wholesale market prices be disseminated to the general public. The Coalition also recommends that the Commission clarify that the foregoing requirement would only be applicable to an MTEF, on a mandatory basis, with respect to contracts, agreements or transactions that are futures contracts or commodity options, although an MTEF may agree to the dissemination of market data without any determination having been made by the Commission that the relevant contract, agreement or transaction constitutes a futures contract or commodity option.

5. Netting.

As with exempt transactions under revised Part 35, the explicit authorization for netting arrangements should extend to the netting of deliveries and delivery obligations.

6. Separation of Exempt MTEFs from other Trading Facilities.

The Coalition believes that the requirement in proposed Rule 36.2(e) that exempt MTEFs be legally separate from designated contract markets, RFEs and DTFs is unnecessarily restrictive and may be confusing.

In particular, it is not clear whether the "facility" referenced in the provision is intended to comprise the network and system components used in the exempt MTEF, or the sponsoring or operating entity. The Coalition recommends that the Commission clarify its intent on this point. There does not appear to be any policy justification for preventing one legal entity from operating two differently regulated markets. Broker-dealers and FCMs, for example, are not required to be legally distinct entities. It should be possible for one entity to comply with the requirements for a Part 36-exempt MTEF *and* a DTF, RFE or designated contract market.

In addition, the ability to use a single system to trade multiple product types involving the same or related asset categories is a potentially important efficiency to be derived from the use of electronic trading facilities. The Commission should not preclude this development or introduce unnecessary obstacles to its accomplishment. The Coalition believes that the requirements imposed in proposed Rule 36.2(f)(1) and (2) are sufficient to address any potential confusion among market participants as to the nature of the trading system they are using and related regulatory implications. The Commission's objective in this respect should be to avoid confusion among system users without imposing artificial constraints on the freedom of system innovators to use the most efficient technological means and forms of legal organization available to accomplish their objectives.

7. Proposed Revisions to the Preamble to Part 36.

In several places, the description of the commodities eligible for transactions on an MTEF, particularly with respect to the last two categories, should be conformed more closely to the definitions in the proposed rule itself.[4]

The preamble also refers, in the context of commodities that are indices or contingencies beyond the control of the parties, to an "independent third party that is widely accepted as a reputable provider of data regarding the commodity." The Coalition believes this reference is inappropriate and may lead to confusion or unnecessary limitations on the scope of the exemption. Parties to derivatives transactions generally designate one party as a calculation agent. The calculation agent is generally subject, under the common law of contract, to exercise any discretion in the determination of a price, rate or level affecting the value of a contract reasonably and in good faith.

The responsibility of a party to determine the value or level of an index or asset is not tantamount to control over the value or level of the reference index or asset. The Commission should therefore clarify that such arrangements do not render a contract involving any such commodity ineligible for the Part 36 exemption.

III. Additional Legal Certainty Measures.

In addition to the recommendation above regarding the Treasury Amendment, the Coalition believes that, in order to maximize the legal certainty relief provided by the Commission to transactions involving non-exempt securities—the category in greatest need of additional legal certainty—the Commission must take additional steps to update the Commission's Swap Policy Statement and Hybrid Interpretation.

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[4] In particular, the discussion in the first two paragraphs at 65 Fed. Reg. 38986, 38989, appears to confuse the requirements of proposed Rule 36.2(b)(6), covering an occurrence or contingency beyond the control of the parties, with Rule 36.2(b)(7), covering a commercial or economic index beyond the control of the parties not based on trading in a directly corresponding cash market.

A. Swap Policy Statement.

The Coalition recommends that the Commission issue a revised and updated Swap Policy Statement redefining the scope of the swap transactions that qualify for the policy statement's safe harbor. The Swap Policy Statement was issued at a relatively early stage in the development of the OTC swap market. Certain of the Swap Policy Statement's criteria are confusing and lead to market practices that are not consistent with prudent risk management and are therefore not consistent with the public interest.[5] These criteria are also not necessary in order to distinguish between contracts appropriately regulated as futures contracts or commodity options and swaps that are not appropriately regulated as futures contracts or commodity options under the CEA.

Specifically, the Coalition recommends that the Commission reissue the Swap Policy Statement clarifying that it applies to swap agreements (including those involving non-exempt securities):

- whose material economic terms (in addition to price and quantity) are subject to individual negotiation; [6] and
- that are entered into, on a principal-to-principal basis, by eligible participants or persons who enter into the transaction in conjunction with their line of business or in order to manage the risk arising from an asset or liability owned or incurred, or reasonably expected to be owned or incurred, by such persons;[7] and
- that are not submitted to a clearing organization for clearance and settlement;[8] and

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5 For example, the requirement in the Swap Policy Statement that a qualifying swap not be subject to a futures-style mark-to-market-margining regime has created uncertainly regarding the use of collateralization techniques that are widely regarded as appropriate for prudent credit risk management purposes. The Coalition believes that it is possible to distinguish between negotiated bilateral forms of credit support, on the one hand, and multilateral forms of credit support arrangements (such as clearinghouses) without imposing undesirable constraints on prudent credit risk management practices.

6 The Swap Policy Statement may be read as suggesting that the material economic terms of a qualifying swap must actually be negotiated, rather than be subject to negotiation. There are innumerable circumstances in which it is not necessary for the parties to a transaction to negotiate specific material economic terms or in which the parties may choose not to negotiate such terms.

7 The Coalition believes that the current requirement that a qualifying swap be entered into in conjunction with a line of business fails to encompass transactions that, while not entered into as part of a business, are entered into to offset the price risk arising from an asset or liability and thus should not be analyzed in isolation from the underlying asset or liability. A swap that must be undertaken, if at all, in conjunction with an offsetting cash market position does not perform the kind of leveraged speculative investment activity that motivated the regulation of futures contracts.

8 See Note 5 above.

- are not marketed as futures contracts or commodity options.

The Coalition believes that the foregoing criteria appropriately distinguish between futures contracts, on the one hand, and those swaps that are not, or in any event should not be subject to regulation as, futures contracts, on the other hand.

B. Statutory Interpretation

The Coalition also recommends that the Commission revise and reissue the Hybrid Interpretation to eliminate anomalous consequences resulting from the application of the interpretation's current commodity independent yield requirement to debt instruments whose payments are indexed or linked to the value of equity or other non-exempt securities. This relief is particularly important in light of the fact that equity-linked and credit-linked hybrid instruments represent a very significant segment of the hybrid instrument market.

The anomalies referenced immediately above can be eliminated in either of two ways.

The most straightforward and efficacious remedy would be elimination of the 50% - 150% commodity independent yield requirement in its entirety, and reliance instead on the economic constraints created by the requirement that qualifying hybrid instruments be unleveraged.[9] In the Coalition's view, this would be an entirely appropriate result for the simple reason that an indexed instrument that is unleveraged is economically equivalent to a cash position and not to either a futures or commodity option position.

In any event, as a practical matter, the yield on a hybrid instrument is determined by: (1) the prevailing cost of funds for the issuer, (2) the net cost of carry associated with any embedded forward position and/or the implied premium value of any embedded option feature, and (3) the cost to the issuer of structuring and issuing the instrument. It is thus not necessary to impose an independent constraint on the yield of a hybrid instrument and, as noted above, imposition of the requirement creates artificial and inappropriate constraints in the context of linkages to equity and other non-exempt securities.

An alternative and more narrow remedy would be the following:

- In the case of a hybrid instrument indexed to the value of an equity security, permit the hybrid issuer to utilize, as an alternative commodity independent yield, the dividend yield on the reference equity security.

- In the case of a hybrid instrument whose issuer has a higher credit rating (and therefore a lower funding cost) than the issuer of other indebtedness to which

[9] The Hybrid Interpretation currently requires that qualifying hybrid instruments be indexed on no greater than a "one-to-one basis" to the value of a commodity.

the hybrid instrument's payments are indexed, permit the hybrid issuer to utilize, as an alternative commodity independent yield, the funding rate payable by the issuer of the referenced indebtedness.[10]

C. Treasury Amendment.

As noted above, the Coalition recommends that the Commission, in consultation with the Department of the Treasury and other members of the President's Working Group, issue an interpretation or exemption in conjunction with the Commission's final rulemaking, consistent with the recommendations of the President's Working Group Report, to clarify the scope of the Treasury Amendment.

The Coalition believes that each of the foregoing measures is extremely important to the accomplishment of the Commission's legal certainty objectives.

IV. Part 37 Exemption for Transactions on a DTF.

A. General Comments.

The Coalition supports the Commission's efforts to create an intermediate category of regulated trading facility subject to more regulation than an MTEF exempt under proposed Part 36 but not subject to the full set of requirements applicable to a designated contract market under existing law or an RFE under proposed Part 38. As the Commission and its staff have recognized, the current monolithic regulatory model under the CEA is not appropriate for all types of transactions, trading systems and market participants. The DTF option will provide a potentially important regulatory alternative and will facilitate the development of new types of trading systems available to a broader range of market participants than Part 36-exempt MTEFs.

B. Recommendations.

1. DTF Name.

As an initial matter, the Coalition recommends that the Commission change the name "derivatives transaction facility" to "registered transaction facility" to be consistent with the approach taken elsewhere in the Proposed Rules, which refer only to "contracts, agreements or transactions," and to avoid any inference by those who are extremely sensitive to jurisdictional nuances that the Commission is proposing unilaterally to extend its regulatory authority over derivative instruments that may not currently be subject to regulation under the CEA.

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[10] This approach is functionally equivalent to the approach adopted by the Commission to address currency-linked hybrid instruments involving currencies having different funding rates.

2. Opting-in to Regulation as a DTF.

The Commission has proposed that a trading facility that is not required to register as a DTF, such as an entity that qualifies for the Part 36 exemption, be permitted to elect voluntarily to do so. This has been referred to as the so-called "opt-in" provision. The Commission has specifically requested comment on this aspect of its rulemaking initiative, and in particular, on the scope of the Commission's authority to exercise jurisdiction in such circumstances.

Many different issues are subsumed within this question. However, the core issues may be summarized as follows:

- *Is the Commission authorized* to utilize its resources to engage in the registration and oversight activities contemplated by Part 37, in circumstances where the Commission has not determined that the underlying transactions are futures contracts or commodity options?

- *Could the Commission enforce compliance or remedy non-compliance* with the requirements applicable to DTFs or participants in those markets if it turns out that the underlying transactions are not futures contracts or commodity options?

- *Should the Commission utilize its resources* to engage in the registration and oversight activities contemplated by Part 37, in circumstances where the Commission has not determined that the underlying transactions are futures contracts or commodity options, and where, as a result, limitations may exist on the Commission's enforcement authority?

(i) Is the Commission authorized?

The Coalition believes that the answer to this question is: "it depends." In the Coalition's view, the Commission would not be authorized to exercise jurisdiction over activities that are clearly outside its jurisdiction under the CEA. Examples of this would include trading in equity options and spot transactions. Accordingly, the Commission would not be authorized to (and, anticipating issue #3, should not) permit a trading facility to "opt into" Commission regulation as a DTF in connection with trading in such products. In this sense, the Coalition believes that the DTF category should not be an "opt-in" category for products that are clearly not within the Commission's jurisdiction.

At the same time, the conferees to the Futures Trading Practices Act of 1992 (the "FTPA") expressly authorized the Commission to exercise its exemptive authority under Section 4(c)(1) of the CEA without determining whether the exempted transactions are subject to the CEA. And they authorized the Commission to do so on such terms and conditions as the Commission deems appropriate. The conferees specifically so provided to enable the

Commission to act without making consequential jurisdictional determinations that might create legal uncertainty for, or imply the illegality of, other transactions.

For precisely the reasons motivating the FTPA conferees, the Coalition believes that the Commission is authorized to and should accept requests by trading facilities who wish to be registered as DTFs and who request that the Commission not make any determination that the underlying transactions are futures contracts or commodity options. The Coalition agrees with the Commission's implicit judgment that this approach will minimize the adverse jurisdictional implications, and therefore the legal uncertainty, that might otherwise arise if one trading facility elects to pursue DTF registration in circumstances where other, possibly analogous trading facilities do not. However, as suggested by the immediately preceding discussion, the Commission should only so proceed in cases where a *bona fide* issue as to its jurisdiction exists and should not so proceed in any case where it is clear that the Commission lacks jurisdiction.

A related question exists as to whether the Commission's authority to grant exemptive relief "on terms and conditions" is limited to terms and conditions which define the scope of activity that is eligible for exemption or whether it includes the authority to impose affirmative, substantive compliance obligations. The answer to this question also is: "it depends."

On the one hand, it is clear that the Commission's exemptive authority includes the authority to replace existing statutory requirements with alternative regulatory requirements. Nothing in the FTPA limits this authority in a manner that precludes affirmative compliance obligations. At the same time, the Commission's authority to grant exemptions from the CEA cannot reasonably be read as authorizing the Commission to adopt affirmative regulations for the swap market. Put differently, the Coalition believes that the conferees intended that the Commission use its exemptive authority to foster legal certainty for swaps and not to establish an affirmative regulatory program for swaps. This is clear from the legislative history of the FTPA.

More generally, the Commission's authority to grant exemptions from the CEA cannot reasonably be read as authorizing the Commission to impose, as a condition to exemption from the CEA, affirmative compliance obligations on participants whose activity is otherwise not subject to the CEA. Where the Commission *does not require* compliance with substantive regulatory requirements in order for a category of transaction to be eligible for exemption, *but permits* compliance with those requirements *on a voluntary basis*, the Coalition believes that the Commission is acting in a manner that is consistent with the FTPA.

(ii) Could the Commission enforce compliance or remedy non-compliance?

It is obvious that the Commission could, as a sanction for non-compliance with DTF regulations, withdraw the registration, or disqualify a principal, of a DTF. It is perhaps equally clear that, in the context of a DTF transaction that is determined not to be a futures contract or commodity option, a market participant generally would not be subject to sanctions and remedies imposed by the Commission under the CEA.

A more difficult question is whether a market participant who agrees voluntarily to subject itself to specific remedies and sanctions under the CEA or otherwise imposed by the CFTC under the CEA, as a condition to an exemption it has voluntarily sought (or as a condition to its participation in a market that has availed itself of such an exemption), would be able to resist the enforcement, in either an administrative or private action, of remedies and sanctions imposed by the Commission under its Section 4(c)(1) "terms and conditions" authority.[11]

Acknowledging that the Commission would have a compelling statutory and equitable position in the situation described immediately above, the Coalition is not in a position to express a definitive legal opinion to the Commission regarding the outcome of such a case. The question remains, however (addressed immediately below), whether the possibility that remedies under the CEA or Commission regulations will be unavailable should deter the Commission from permitting facilities to register as a DTF without making a determination that the underlying transactions are futures contracts or commodity options.

(iii) Should the Commission utilize its resources?

Whether the Commission *should* utilize its resources to register and regulate a DTF that requests no determination that the underlying transactions are futures contracts or commodity options is ultimately a question of authorization and how the public interest is best served. As noted above, the Coalition believes that the Commission has the statutory authority to register facilities as DTFs without determining that the underlying transactions are futures contracts or commodity options. As noted above, the Coalition also believes that doing so would be consistent with the public interest in minimizing legal uncertainty, consistent with the views expressed by the FTPA conferees.

The obvious countervailing public interest consideration is the risk implicit in creating a false impression of a safe marketplace or the availability of remedies for misconduct. Clearly, if the Commission determines that it is able to establish the DTF program in a manner that will enable the Commission and private parties to enforce relevant statutory and regulatory provisions, this issue disappears. However, for the reasons discussed immediately below, even if the Commission is unable to make such a determination with a high degree of confidence, the Coalition believes that the public interest will nonetheless be better served by permitting trading facilities to register as DTFs without requiring a determination by the Commission that the underlying transactions are futures contracts or commodity options.

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11 It should be noted that the question at issue here is whether the Commission should proceed to register a DTF in appropriate circumstances without making a determination that the underlying transactions are futures contracts or commodity options. The fact that the Commission makes a determination internally that a transaction is a futures contract or commodity option, however, does not eliminate the risk that a court will disagree with the Commission. Accordingly, this risk will exist to a certain respect regardless of the path selected by the Commission.

- Perceptions of market participants. In order to avoid misleading perceptions among market participants, the Coalition recommends mandated disclosure by a trading facility that requests registration as a DTF without a determination by the Commission that the transactions conducted on the facility are futures contracts or commodity options. In broad strokes, the disclosure would clarify:

  - that the Commission has made no determination that transactions on the DTF are subject to regulation as futures or commodity options under the CEA; and

  - the Commission has not determined and there is no assurance that remedies under the CEA will be available in respect of transactions conducted on the DTF.

- Actual market safety. A significant component of the market protections afforded by DTF regulation lies in the registration process itself and the ongoing transparency and other affirmative regulatory obligations of a DTF. Put differently, simply registering and operating as a DTF in compliance with the DTF requirements provides a significant public interest benefit vis-à-vis the alternative scenario in which a trading facility that is not subject to the CEA operates entirely outside the DTF or any other regulatory framework.[12]

  While there is a risk of actual noncompliance with DTF compliance obligations, this risk also exists in other regulated markets. In each case, the condition lasts until discovered. It may be argued that a DTF that is not subject to administrative sanctions or remedies has less incentive to actually comply with the regulatory obligations to which it is subject. The Coalition believes, however, that a DTF that seeks the regulatory status under discussion is likely to have adequate compliance incentives from the risk of disqualification, the associated reputational stigma and potential common law or other sources of legal liability for misconduct.

- Unavailability of CEA or Commission imposed sanctions and remedies. To a significant extent, the most serious forms of misconduct in financial markets involve some form of fraud, breach of fiduciary responsibility or manipulation. State law remedies for fraud and breach of fiduciary responsibility are comprehensive and the relevant bodies of law, by and large, are extremely well developed. The absence of a remedy under the

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[12] The Coalition does not intend to suggest by this observation that trading facilities are not adequately motivated, absent regulation, to operate in a fair and orderly manner.

CEA is in no respect tantamount to no remedy. The antimanipulation provisions of the CEA, however, proscribe manipulation not only of futures prices, but also of the prices of commodities in interstate commerce. Accordingly, it is arguable that the antimanipulation provisions of the CEA would be applicable irrespective of the jurisdictional status of the DTF.

In any event, recalling that this discussion involves a hypothetical DTF whose traded products do not subject it to CEA regulation, the position of participants on this facility, subject to the discussion in the first bulleted paragraph immediately above, would be no worse than it would be had the Commission precluded registration of the DTF.

3. Definition of Eligible Commercial Participant.

The Coalition recommends the following modifications to the definition of eligible commercial participant in proposed Rule 37.1(b).

- References to "underlying physical commodity" should be changed to "underlying commodity" so that the exemption would be available to commercial participants in transactions involving intangible commodities, such as telecommunications minutes or bandwidth, as well as physical commodities.

- The list of eligible participants qualified to be eligible commercial participants should be expanded to include broker-dealers and FCMs (as defined in proposed Rules 35.1(b)(9) and (10)).

- To eliminate certain ambiguities, the Coalition recommends expanding the definition of eligible commercial participant to include persons "regularly engaged in the business of buying or selling the underlying commodity or entering into derivative contracts, agreements or transactions based on the underlying commodity."

4. Permissible Contracts.

- In situations where access to the DTF is not limited to eligible commercial participants trading for their own accounts, the definition of permissible underlying commodities for transactions exempt under proposed Rule 37.2(a)(2) should incorporate the suggested modifications described in Section II.B.1 above in connection with proposed Part 36.

- The Coalition recommends that the standard for permitting transactions involving additional underlying commodities to be traded on a DTF under proposed Rule 37.2(a)(2)(ii) should be whether the commodity is "not

readily susceptible to manipulation," the standard used elsewhere in the CEA, or "not subject to a significant risk of manipulation," rather than "highly unlikely to be manipulated," the meaning of which is uncertain and may be unnecessarily restrictive. The Coalition would be pleased to work with the Commission and its staff to clarify this standard.

5. Transparency.

The Application Guidance for Core Principle #4, relating to transparency, should clarify that the reference in the Core Principle to "as appropriate to the market" is intended to recognize that public disclosure of trading data should not be required for certain types of DTFs, such as those that are limited to wholesale or professional traders and on which other end-users may not participate. This approach would be consistent with the nature of the types of commercial or wholesale markets that the Part 37 exemption is intended to facilitate.

6. Financial Integrity.

The Commission for the first time in this rulemaking initiative is decoupling execution and clearance as functions and as objects of regulatory oversight. The Coalition agrees with this approach. As part of this approach, however, a DTF itself should not be obligated, as it would be under proposed Rule 37.3(a)(3), in the alternative, either to ensure the financial integrity of transactions entered into on the facility or to have a financial framework applicable to such transactions. Consistent with proposed Rule 37.2(d), DTFs should not be required to utilize a recognized clearing organization (an "RCO") or to provide other forms of financial integrity. It should also be clarified that a DTF has no vicarious responsibility for the failure of any associated RCO.

DTF participants, together with the facility, should be permitted to determine the availability, if any, and scope of any financial integrity arrangements or other financial framework applicable to transactions on the facility.

6. Insolvency.

The Coalition believes it would be extremely desirable for transactions on DTFs (as well as RFEs) to enjoy the status under the Bankruptcy Code of transactions conducted on a designated contract market (whether or not cleared by a clearing organization). The Coalition accordingly believes it would be preferable for the Commission to constitute DTFs (and RFEs) as types of contract markets under the CEA.

V. Part 39: Recognized Clearing Organizations.

A. General Comments.

The Coalition strongly endorses the Commission's proposal to permit the clearing of OTC derivatives transactions effected pursuant to the proposed Part 35 and 36 exemptions.

This proposal would eliminate a key limitation of the Existing Swap Exemption. In addition, as noted in the President's Working Group Report, clearing of such transactions could significantly reduce credit and systemic risks as the size of the OTC derivatives markets continues to increase. It would also permit U.S. derivatives markets and trading facilities to keep pace with those in other jurisdictions where clearing for OTC derivatives is already established or permitted.

In particular, the Coalition supports the Commission's determination, which is consistent with the President's Working Group Report, to permit clearing of these transactions by clearing organizations registered with any of the Securities and Exchange Commission, federal banking authorities and appropriate foreign regulators, in addition to the Commission. This degree of flexibility is appropriate in light of the diversity of participants and types of transactions conducted in the OTC derivatives markets. It would also facilitate development of clearing of OTC derivatives by allowing existing clearing organizations to extend their facilities to OTC derivatives without having to register with or be overseen by an additional regulatory authority.

More generally, the Coalition also welcomes the Commission's proposal to regulate clearing organizations separately from the contract markets, RFEs, DTFs and other facilities for which they clear transactions. This approach should facilitate clearing across transactions on different trading facilities and thereby help further reduce systemic risk.

B. Recommendations.

The Coalition suggests the following modifications to the Part 39 proposal:

- It is highly desirable that transactions cleared by a clearing organization be eligible for the same treatment under the Bankruptcy Code afforded transactions conducted on a contract market. However, proposed Rule 39.1(b)(2), in attempting to implement this objective, has the unintended consequence of making all transactions that are conducted under Part 35 and 36 and that are cleared by an RCO, transactions conducted on a contract market, with potentially significant consequences for regulated market participants, such as FCMs, CTAs and CPOs, who otherwise enjoy exemptions available to them for transactions that are not conducted on contract markets.

- The Coalition does not believe that a clearing organization should be required to provide dispute resolution mechanisms for customer member disputes, as proposed under Rule 39.3(c)(7).

- The Coalition believes that it would be desirable to expressly permit a clearing organization not required to register with the Commission under proposed Part 39 nonetheless to elect to so register.[13]

[13] See the discussion in Section IV.B.2 above.

- In addition, RCOs should be expressly authorized to clear transactions not subject to Part 39 or otherwise subject to the Commission's jurisdiction.

- The reference in proposed Rule 39.1(b)(1) to "all cleared transactions" should be replaced with a reference to "all transactions submitted to a clearing organization".

- The Coalition does not believe a stand-alone antifraud provision with respect to cleared transactions, such as proposed Rule 39.6, is necessary. The Commission already has antifraud authority with respect to transactions on designated contract markets, and would retain such authority with respect to transactions exempt pursuant to Parts 35, 36, 37 and 38. Other types of transactions not otherwise subject to the CEA should not become subject to the Commission's antifraud authority solely because they are cleared by an RCO.

- With respect to proposed Rule 39.3(c)(1), the Coalition believes that the appropriate standard is that the organization be able to fulfill its obligations without interruption in *reasonably foreseeable* market conditions. It is not feasible for an applicant to demonstrate that it will be able to satisfy its obligations under any possible market condition, no matter how remote.

- The core principles should generally clarify that standards and procedures for protecting client funds and property are required only for the clearing of intermediated transactions and only to the extent stipulated by the CEA. These provisions should not, for example, be applicable to transactions exempt under proposed Part 35 or 36 or other principal-to-principal transactions.

- Similarly, entering into information-sharing arrangements may not be appropriate for all clearing organizations, such as those that only clear transactions effected pursuant to Parts 35 and 36.

VI. Conclusion.

The Proposed Rules represent a comprehensive, well-designed approach to enhancing legal certainty for OTC derivatives and establishing a tiered approach to the regulation of derivatives transactions executed on trading systems, in lieu of the current one-size-fits-all approach for designated contract markets. The Coalition wishes to commend the Commission on the extent to which it has been able to accomplish these goals within the limitations of the existing CEA and the Commission's exemptive authority under Section 4(c) of the CEA.

Accordingly, the Coalition urges the Commission to adopt the Proposed Rules as expeditiously as possible, subject to the recommendations described above.

The Coalition appreciates the opportunity to submit these comments in response to the Proposed Rules and the Releases and would be pleased to work further with the Commission and other interested parties to advance the rulemaking process. If the Commission or its staff has any questions regarding this letter, please do not hesitate to contact the undersigned (tel. 212-225-2820) or Geoffrey B. Goldman (tel. 212-225-2234).

Very truly yours,

Edward J. Rosen

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