

# ISDA

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Commodity Futures Trading Commission  
Three Lafayette Center  
1125 Twenty First Street, N.W.  
Washington, D.C. 20581

Attention: Office of the Secretariat

Re: Regulatory Reinvention

Ladies and Gentlemen:

This letter contains comments on rules proposed by the Commodity Futures Trading Commission (the "Commission") and published in the Federal Register for June 22, 2000 (65 Fed. Reg. No. 121 at 38986 et seq.) entitled:

- (1) Exemption for Bilateral Transactions (the "Bilateral Proposal"); and
- (2) A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations (the "Multilateral Proposal").

The International Swaps and Derivatives Association, Inc. ("ISDA") is an international organization and its more than 475 members include the world's leading dealers in off-exchange derivatives transactions (collectively, "OTC derivatives transactions"). These dealers are among the principal users of the futures exchanges that are regulated by the Commission under the Commodity Exchange Act (the "CEA"). In addition, ISDA's members include many of the businesses, financial institutions, governmental entities and other end users that rely on OTC derivatives transactions to manage their financial and commodity market risks with a degree of efficiency and effectiveness that would not otherwise be possible.

### Importance of the Commission's Regulatory Initiative

ISDA welcomes the decision of the Commission to proceed with its Regulatory Reinvention initiative and to address issues related to OTC derivatives transactions as part of that initiative. OTC derivatives are powerful tools that enable businesses and other end users to manage the interest rate, currency, commodity, credit and other related risks that are inherent in their core economic activities. This enables these end users to lower their cost of capital, manage their credit exposures, and increase their competitiveness by focusing on their core areas of expertise.

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The dramatic growth in the volume and diversity of OTC derivatives transactions provides compelling evidence of their importance to, and acceptance by, end users. It is no coincidence that the U.S. economy and the volume of OTC derivatives transactions grew dramatically in the last decade. As Secretary of the Treasury Summers testified before the Committee on Agriculture, Nutrition and Forestry of the United States Senate on June 21, 2000, “[t]he over-the-counter derivatives market is an important component of the American capital markets and a powerful symbol of the kind of innovation and technology that has made the American financial system as strong as it is today.”

This growth did not occur in a vacuum. It was fostered by this Commission in an earlier regulatory initiative commencing with the release of the Swaps Policy Statement in 1989 and continuing with the promulgation of the Swaps Exemption (17 CFR Part 35) and the Hybrids Exemption (17 CFR Part 34). These latter actions were of course entirely consistent with the intent of Congress, as reflected in the enactment of the Futures Trading Practices Act of 1992 (Public Law 102-546). The pivotal role that OTC derivatives transaction now play in our economy is an outgrowth of these earlier policies of the Commission and the continuing expressions of support for those policies by Congress. ISDA believes that the proposed regulatory initiative now under consideration can and should be viewed as a vital and positive step in carrying out the Commission’s long-standing policy with respect to OTC derivatives.

ISDA believes that, as discussed more fully below, the proposed regulatory initiative is an important change for the better. We applaud the sensitivity of both the Commission and its professional staff to the need to avoid structuring the proposals in ways that could result in legal *uncertainty* and we believe that the proposals *will not* have this effect. We likewise applaud the decision of the Commission to propose specific actions intended to increase, within the parameters of the CEA, legal certainty and we believe the proposals *will* have this effect. We therefore urge the Commission, after incorporating such amendments as are appropriate following the close of the comment period, to move expeditiously to adopt both the Bilateral and Multilateral Proposals.

As noted above, ISDA’s dealer-members are also among the principal users of the regulated futures exchanges. ISDA is therefore supportive of the Commission’s decision to propose comprehensive regulatory relief for those exchanges.

The specific comments below are directed to those portions of the regulatory initiative proposals that present questions related to the legal certainty issue.

### The Bilateral Proposal

Need for a New Bilateral Exemption. ISDA welcomes the proposal to replace the existing Swaps Exemption with a new Exemption for Bilateral Transactions. Financial innovations occurring since the adoption of the Swaps Exemption in 1993 make this action necessary to ensure that new and evolving risk management tools will enjoy comparable legal certainty under the CEA with those products that were available when the Swaps Exemption was originally issued.

The proposed Bilateral Exemption will make a major contribution to legal certainty. First, references to “swaps” would be replaced with references to a “contract, agreement or transaction”. This will enable market participants to focus on legal and economic substance rather than labels. Second, the existing requirement that exempt transactions not be fungible or standardized would be eliminated. This will eliminate a potential source of uncertainty with respect to the scope of the exemption. Finally, the clearing of transactions would no longer result in disqualification under the exemption. This will eliminate the “Hobson’s Choice” that now exists between legal certainty and the use of clearing to reduce systemic risk.

We are pleased that the Bilateral Proposal (and the Multilateral Proposal as well) make it clear that the proposed actions do *not* reflect any determination by the Commission that exempted transactions are subject to its jurisdiction. This is entirely consistent with Congress’ intent in granting exemptive authority to the Commission in 1992 and the inclusion of an explicit statement to this effect will contribute the goal of ensuring that the proposed regulatory initiative will not create ambiguity with respect to perceptions of the Commission’s views of its jurisdiction.

Suggested Changes. ISDA believes that certain changes should be made to the Bilateral Proposal. Suggested amendments to the Bilateral Proposal to effect these changes are attached as Exhibit 1. First, ISDA suggests that the definition of “eligible participant” should be updated and clarified in certain respects. In particular, we believe it would be useful to clarify the status of (1) foreign banks and their U.S. branches and agencies, (2) insurance company subsidiaries and affiliates and (3) agency and fiduciary transactions on behalf of eligible participants.

Second, ISDA believes that the Bilateral Proposal should be clarified to establish that the determination whether a party is an “eligible participant” is to be determined by reference to whether there was a reasonable belief at the time the transaction was entered into that a party was an “eligible participant”. Finally, ISDA believes that both principal-to-principal and agency transactions should be encompassed by the Bilateral Exemption subject only to the requirement that only “eligible participants” be involved. Sophisticated parties should be able to deal on either a principal or an agency basis.

Swaps Policy Statement. Under the CEA, bilateral contracts involving non-exempt securities cannot qualify for the Swaps Exemption and they will not be eligible for the Bilateral Exemption. These transactions must therefore rely on the 1989 Swaps Policy Statement to provide legal certainty with respect to their status under the CEA. We believe that it is imperative that the Commission act promptly to update the Swaps Policy Statement to incorporate the principles embodied in the new Bilateral Exemption and that, as so revised, the Swaps Policy Statement should be reissued simultaneously with the final new Bilateral and Multilateral Exemptions.

### The Multilateral Proposal

Need for the Exempt MTEF Rule. The proposed Bilateral Exemption, like the existing Swaps Exemption, is not applicable to transactions effected on a multilateral transaction execution facility (an "MTEF"). The use of electronic trading systems is desirable as a matter of public policy as these systems promote financial innovation, efficiency and transparency. For these reasons, clarifications contained in the Exempt MTEF proposal are of critical importance to ISDA and its members.

As noted earlier, in 1992 Congress made clear its intent that the eligibility of any class of contracts for an exemption such as the Exempt MTEF rule should not create any inference that the exempted contracts were otherwise subject to the Commission's jurisdiction. ISDA is pleased that, in structuring this self-executing exemption, the Commission did not subject Exempt MTEFs to rules (such as a free-standing anti-fraud rule) that could create uncertainty concerning the Commission's views either as to the scope of its jurisdiction under the CEA or the classification of one or more categories of OTC derivatives contracts under the CEA.

Suggested Changes. ISDA believes that certain changes should be made to the Multilateral Proposal. Suggested amendments to the Multilateral Proposal to effect these changes are attached as Exhibit 2. First, ISDA believes that electronic trading facilities for bilateral transactions that include a credit screen or filter should be *excluded* from the definition of a "multilateral transaction execution facility". The inclusion of a credit test is a significant difference between systems that facilitate bilateral trading from multilateral trading on an exchange. This proposed exception from the Exempt MTEF rule would materially enhance the development of electronic trading systems in the United States without impairing the ability of the Commission to carry out its statutory mandates.

ISDA also believes that Commission should reconsider its decision to exclude certain categories of underlying commodities from the types of commodities which can provide the basis for exempt contracts, agreements or transactions conducted on a multilateral transaction execution facility. First, ISDA believes that an additional category of permitted underlying commodities should be added for those energy products for which there now is a sufficiently deep and liquid market to permit designation by the Commission at this time.

A second category of eligible commodities should be those that over time become traded in sufficient volume so as to be highly unlikely to be susceptible to manipulation. In view of the history of the dynamic development of OTC derivatives transactions, ISDA believes that the Commission should build into the Exempt MTEF rules sufficient flexibility to permit it in the future to respond on a timely basis to market developments.

### Non-Repudiation Provisions

The Regulatory Reinvention proposals also contain a series of provisions that are intended to limit the ability of a party to an OTC derivatives transaction that is reasonably believed to be an "eligible participant" from repudiating, rescinding or recovering a payment made. These provisions will reduce legal uncertainty in a helpful manner because they deal directly with the main source of legal risk under the CEA.

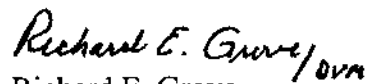
Moreover, the non-repudiation provisions are critical to the preservation of market stability and the avoidance of systemic risk. They need to be adopted by the Commission promptly as a safeguard during future periods of volatility in the financial markets.

### Conclusion

ISDA believes that legislation is necessary to modernize the CEA to provide comprehensive legal certainty for OTC derivatives transactions. Although much progress has been made, there can be no assurance that such legislation will be enacted by Congress this year despite the efforts of the Commission and the other agencies comprising the President's Working Group on Financial Markets, as well as the efforts of key members of Congress and private sector groups such as ISDA. Consequently, it is important for the Commission to continue to move forward expeditiously to adopt the Bilateral Proposal and the Multilateral Proposal.

ISDA believes that the Commission and its professional staff deserve credit for the direction and scope of Regulatory Reinvention initiative and for the continuing commitment both to avoid creating new legal uncertainties and provide increased legal certainty. ISDA and its member firms have appreciated the opportunity to work with the Commission and its staff from the outset of the process and we look forward to continuing to do so in a constructive and cooperative manner.

Very truly yours,



Richard E. Grove  
Chief Executive Officer  
and Executive Director

Exhibit 1 to ISDA Comments on Regulatory Reinvention

1. Amend proposed Part 35.1(b)(1) by adding the following at the end thereof:

“ . . . or a foreign bank or a branch or agency of a foreign bank (as defined in section 1(b) of the International Bank Act of 1978 (12 USC sec. 3101(b)).”

2. Amend proposed Part 35.1(b)(3) by adding the following at the end thereof:

“ . . . (including a subsidiary or an affiliate of an insurance company).”

3. Delete proposed Part 35.1(b)(10) and substitute the following therefor:

“(A) a person described in any of paragraphs (b)(1) through (9) of this section, acting as broker or performing an equivalent agency function on behalf of another person described in any of paragraphs (b)(1) through (9) or (11) of this section, or

“(B) an investment adviser subject to regulation under the Investment Company Act of 1940, a commodity trading advisor subject to regulation under the Act, a foreign person performing a similar role or function subject as such to foreign regulation, or a person described in any of paragraphs (b)(1) through (9) of this section, in any such case acting as investment manager or fiduciary for another person described in any of paragraphs (b)(1) through (9) or (11) of this section and who is authorized by such person to commit such person to the transaction.”

4. Revise proposed Part 35.2(a) to read as follows:

“(a) The contract, agreement or transaction is entered into solely by persons reasonably believed by their counterparty to be at the time of entering into the transaction eligible contract participants trading for their own account or through another eligible contract participant;” (Material to be inserted underscored.)

5. Revise proposed Part 35.3(b)(2) to read as follows:

“(2) to rescind or recover any payment made in respect of such contract, agreement, or transaction, based solely on the failure of such party or such contract, agreement, or transaction to comply with (i) the terms and conditions of the exemption under this part, (ii), the terms and conditions of the Statement of Policy Concerning Swap Transactions in Appendix A to this Part 35, or (iii) any provision of this Act or any other Commission rules or exemptions. (Material to be inserted underscored.)

6. Revise proposed Part 35.3(c) by inserting “or exemptions,” between “Commission rules” and “excluding”.

Exhibit 2 to ISDA Comments on Regulatory Reinvention

1. Revise proposed Part 36.1(b) by deleting “or” at the end of subdivision (ii), inserting “or” at the end of subdivision (iii) and adding the following new subdivision at the end thereof:

“(iv) any electronic communications system that enables participants to enter into bilateral transactions and 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.”

2. Revise proposed Part 36.2(a) to read as follows:

“(a) Only parties reasonably believed to be eligible participants. . . .” (Material to be inserted underscored.)

3. Revise proposed Part 36.2(b)(2) by deleting “foreign”.

4. Revise proposed Part 36.2(b) by deleting “or” at the end of paragraph (6), inserting “or” at the end of paragraph (7) and adding the following new paragraph at the end thereof:

“(8) A commodity listed in Appendix A or a commodity otherwise determined by the Commission to not be susceptible to a material risk of manipulation in the context of the relevant contract, agreement or transaction.”

5. Revise the proviso in proposed Part 36.2(c) to read as follows:

“Provided, however, that nothing in this paragraph precludes: (1) agreements or facilities between parties to such contracts, agreements or transactions that provide for the netting of payment obligations or termination values resulting from such contracts, agreements or transactions; or (2) arrangements or facilities among parties to such contracts, agreements or transactions, that provide for netting of payments or termination values resulting from such contracts, agreements or transactions.” (Material to be inserted underscored.)

6. Revise proposed Part 36.2(f)(1) by inserting “types of” between “the” and “agreements”.

7. Revise proposed Part 36.3(b)(ii) to read as follows:

“(ii) to rescind or recover any payment made in respect of such contract, agreement or transaction, based solely on the failure of such party or such contract, agreement or transaction to comply either with the terms and conditions of the exemption under this part or any provision of the Act or any other Commission rules or exemptions.” (Material to be inserted underscored.)