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August 21, 2000

BY ELECTRONIC MAIL

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

COMMENT

Re: Regulatory Reinvention; Exemption for Bilateral Transactions

This letter comments on two rulemakings recently proposed by the Commission: "A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations," 65 Fed. Reg. 38986 (June 22, 2000); and "Exemption for Bilateral Transactions," 65 Fed. Reg. 39033 (June 22, 2000). The comment is filed by Covington & Burling, a law firm with domestic offices in Washington, DC, New York, and San Francisco.

We strongly support the proposed rulemakings as providing substantially greater legal certainty for derivative instruments. In particular, the two proposals taken together expressly recognize that derivative instruments should generally be exempt from regulation under the Commodity Exchange Act ("CEA") if they are (1) traded among or between sophisticated counterparties ("eligible participants"); (2) based on certain types of underlying instruments or measures that pose a "relatively low susceptibility to manipulation" ("exempt commodities")¹; and (3) if cleared, are cleared by an authorized clearing organization.²

¹ 65 Fed Reg. at 38988. The list of exempt commodities consists of contracts, agreements or transactions based on (a) debt obligations; (b) foreign currency; (c) interest rates; (d) exempt securities; (e) measures of credit quality; (f) occurrences or contingencies beyond the control of counterparties; or (g) economic or commercial indexes or measures, so long as the derivatives are cash-settled and certain other conditions are met. Proposed 7 C.F.R. § 36.2(b), 65 Fed. Reg. at 38999.

² Transactions subject to the exemption would still be subject to the anti-fraud and anti-manipulation provisions of the CEA, to the extent such provisions would otherwise apply. Proposed 7 C.F.R. § 36.3, 65 Fed. Reg. at 38999; proposed 7 C.F.R. § 35.3, 65 Fed. Reg. at 39035.

Derivative transactions satisfying these three conditions would be exempt from virtually all CEA regulation if they satisfied these three conditions and *either* (1) *were* traded on a multilateral transaction execution facility ("MTEF"), under newly-proposed Part 36 of the Commission's regulations³; *or* (2) *were not* traded on an MTEF, under newly revised Part 35 of the Commission's regulations.⁴ Thus, participants in transactions that satisfy the three conditions would obtain legal certainty about the limited scope of CEA regulation regardless of whether the means for executing transactions did or did not satisfy the technical definition of an "MTEF."

As provided in the preamble to the newly-proposed Part 36, the Commission expressly intended to achieve this type of definitional legal certainty for derivatives transactions that satisfy the three conditions:

The Commission is of the view that [exempt] commodities, when traded between or among eligible participants need not be subject to the regulatory scheme of the [CEA]. Accord [President's Working Group] Report at 17. In this regard, transactions in these commodities would be exempt from Commission regulation under either the Part 35 exemption for bilateral transactions or under the Part 36 exemption for MTEFs.⁵

We strongly agree with the Commission's conclusion that derivative transactions in exempt commodities engaged in by eligible participants should not be subject to the regulatory scheme of the CEA, regardless of whether the transactions occur on or off of an MTEF. In order for emerging markets and trading facilities in exempt commodities to flourish, participants need such legal certainty regarding the limited scope of CEA regulation, regardless of whether a particular trading facility does or does not qualify as an MTEF.

It is our understanding that several comments have been filed with the Commission that seek changes to the proposed regulations in ways that conceivably could affect the legal certainty described above, including the Commission's statement supporting such legal certainty. We urge the Commission not to make any changes that would affect the

³ Proposed 7 C.F.R. § 36.2, 65 Fed. Reg. at 38999. In addition to the three fundamental conditions cited in the text, the MTEF exemption is also contingent on the MTEF (a) not holding itself out as regulated by the Commission; (b) maintaining legal separation from any designated contract market, recognized futures exchange, or derivatives transaction facility; (c) satisfying certain notice and physical segregation requirements under certain circumstances; and (d) publicly disseminating certain trading information, if the MTEF is deemed a significant source for price discovery for the underlying commodity. *Id.*

⁴ Proposed 7 C.F.R. § 35.2, 65 Fed. Reg. at 39035.

⁵ 65 Fed. Reg. at 38988.

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interrelationship between the MTEF exemption and the Bilateral Transactions Exemption in a manner that would diminish the legal certainty provided to eligible participants trading exempt commodities. Indeed, it is our view that, if the Commission decides to change the proposed regulations to deprive eligible participants of such legal certainty, it should provide notice and an opportunity for additional comment from interested parties before making any such change a part of the final regulations.

Thank you for this opportunity to comment on the proposed regulations.

Sincerely,

John C. Dugan