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COMMENT

September 14, 2000

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 and 39 of the CFTC's Rules: *Exemption for Bilateral Transactions*, *Regulatory Reinvention* and *Clearing Organizations Reinvention*

Dear Ms. Webb:

The OTC Derivative Products Committee (the "Committee") of the Securities Industry Association (the "SIA")[1] is submitting this comment letter in response to the Commodity Futures Trading Commission's (the "CFTC") releases published June 22, 2000, regarding the captioned proposed rules (the "Proposed Rules").

The Committee greatly appreciates the chance to comment on the Proposed Rules, which form part of a comprehensive and important rulemaking initiative by the CFTC intended to promote the legal certainty of over-the-counter ("OTC") derivatives under the Commodity Exchange Act (the "CEA") and more generally reevaluate the regulatory framework applicable to regulated futures exchanges and clearing organizations under the CEA.

The Committee believes that it is critical to the continued strength of the U.S. financial markets and their status as a favorable jurisdiction for innovation in OTC derivative products to resolve certain significant existing legal uncertainties with respect to OTC derivatives under the CEA. The Committee has strongly supported the efforts in this regard of the CFTC and other members of the President's Working Group on Financial Markets, culminating in the Working Group's 1999 report, *Over-the-Counter Derivatives and the Commodity Exchange Act* (the "President's Working Group Report").

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[1] The Securities Industry Association brings together the shared interests of more than 740 securities firms to accomplish common goals. SIA member firms (including investment banks, brokers-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U. S. securities industry manages the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans. The industry generates more than $300 billion of revenues yearly in the U.S. economy and employs more than 600,000 individuals. (More information about the SIA is available on its home page: http://www.sia.com.)

The Committee continues to believe that legislation may be necessary to achieve fully the goals of the President's Working Group Report. Absent legislation, however, the Proposed Rules, if adopted, would represent a substantial advance toward eliminating some of the legal uncertainties identified in the President's Working Group Report, particularly for OTC derivatives transactions executed on electronic trading systems. The Committee accordingly urges the CFTC to adopt them as final rules, subject to the modifications and suggestions set forth below.

Nonetheless, the Committee believes that there are several important sources of legal uncertainty affecting the OTC derivatives business under the CEA which have not been addressed by the Proposed Rules and which the CFTC should attempt to resolve, either as part of this rulemaking or in a separate initiative. In particular, in order to address the status of OTC derivatives involving non-exempt securities, the CFTC should reissue and update its Policy Statement Concerning Swap Transactions (the "Swap Policy Statement") and Statutory Interpretation Concerning Hybrid Instruments (the "Hybrid Interpretation"). In the Committee's view, the CFTC should also issue an exemption or interpretation confirming the status of government securities and foreign exchange transactions under the so-called Treasury Amendment, section 2(a)(1)(A)(ii) of the CEA.

The following discussion focuses on (i) significant issues relating to legal certainty that have not been addressed by the Proposed Rules, (ii) the revised Part 35 exemption for "bilateral" transactions, (iii) the proposed new Part 36 exemption for transactions executed on a multilateral transaction execution facility (an "MTEF") and (iv) the treatment of clearing organizations under proposed Part 39. The Committee does not intend to comment specifically on the other aspects of the CFTC's current rulemaking initiative.

I. Issues and Products Not Addressed by the Proposed Rules.

The Proposed Rules represent a significant step toward reducing existing legal uncertainties affecting the OTC derivatives markets under the CEA. The revisions to the Part 35 exemption (the "Existing Swap Exemption"), as described in Part II below, would, for example, reduce concerns created by the existing requirement that covered transactions not be part of a "fungible class of agreements standardized as to their material economic terms." By expressly permitting clearing of OTC derivatives, the revisions would help mitigate credit and related risks arising from these transactions. Part 36 would resolve another principal limitation of the Existing Swap Exemption by expressly exempting from the CEA transactions that meet specified criteria between eligible participants executed on an MTEF.

Nonetheless, the Proposed Rules would not significantly improve the status of the category of OTC derivatives transactions that is perhaps in greatest need of additional legal certainty under the CEA—transactions involving non-exempt securities. In addition, the Committee believes that the Proposed Rules do not go far enough in ensuring the legal certainty of transactions involving government securities and other products covered by the Treasury Amendment.

A. **Non-Exempt Securities**.

The legal uncertainty affecting OTC derivatives transactions is perhaps most acute for transactions involving non-exempt securities. While the Committee recognizes that Section 2(a)(1)(B)(v) of the CEA limits the CFTC's exemptive authority in this area, the Committee believes there are significant steps that the CFTC could nonetheless take to alleviate the concerns of participants in this sector of the OTC derivatives markets.

The CFTC has taken a significant step toward this goal through proposed Rule 35.3(c). This provision represents a novel approach to reducing the possibility that a party to a transaction entered into in reliance on, and complying with, the Swap Policy Statement or Hybrid Interpretation could repudiate the transaction based on a claim that the transaction nonetheless violates the CEA or the CFTC's rules. If adopted, this provision would address one of the most serious legal risks to participants in the market for OTC equity derivatives and other transactions entered into in reliance on these interpretations.

Provisions such as proposed Rule 35.3(c), however, are insufficient to address the fundamental limitations and unclear criteria of the Swap Policy Statement and Hybrid Interpretation that give rise to legal uncertainty under the CEA. These interpretations were developed and issued at an early stage in the evolution of the OTC derivatives and hybrid markets and represent an attempt to distinguish such products from exchange-traded futures contracts. As experience with these products and these interpretations has evolved, the need to revisit, clarify and modify some of the criteria in these interpretations has become clear. In particular, in certain cases, these criteria have caused market participants to structure transactions in ways that cannot be justified from a commercial perspective and are inconsistent with prudent risk management and the public interest in the soundness of financial markets. In addition, because the proposed new Rule 35.3(c) nonrepudiation protections would be predicated on compliance with these interpretations, updating these criteria has become all the more important.

The Committee accordingly believes that the CFTC should, in connection with this rulemaking, reissue and update the Swap Policy Statement and Hybrid Interpretation as set forth below to reflect the current state of development of the OTC derivatives and hybrid markets and eliminate some of the now-unnecessary limitations of these interpretations.

(i) **Swap Policy Statement**.

In the Committee's view, the CFTC should revise the Swap Policy Statement to state that swap transactions (including those involving non-exempt securities) meeting the following criteria should not be subject to regulation as futures contracts or commodity options:

- the material economic terms (in addition to price and quantity) of the transaction are subject to individual negotiation;
- the transaction must be entered into on a principal-to-principal basis by eligible participants or by persons who enter into the transaction in connection with their line of business or 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;

- the transaction is not submitted to a clearing organization for clearance or settlement; and

- the transaction is not marketed as a futures contract or commodity option.

This revised formulation would eliminate in particular the requirement that covered swap agreements not be primarily or routinely supported by mark-to-market margin designed to eliminate individualized credit risk. The existing Swap Policy Statement has created considerable uncertainty as to the extent to which equity swaps and other derivatives entered into in reliance thereon may be supported by collateral arrangements. OTC derivatives entered into under the Existing Swap Exemption often are supported by mark-to-market collateral arrangements using cash and other types of collateral, which arrangements significantly mitigate credit exposures. The uncertainty as to the status of such arrangements under the Swap Policy Statement, however, has created an incentive for parties to enter into transactions without appropriate collateral provisions or with collateral provisions that are less protective than would otherwise be desirable from a commercial perspective. In the Committee's view, the type of collateral arrangement used should be irrelevant to distinguishing an OTC derivatives contract from a futures contract. In light of the considerable credit risks caused by the current interpretation, the Committee believes that the CFTC should clarify that collateral arrangements of any kind, other than clearing, would not make a transaction ineligible for the Swap Policy Statement.

In addition, the Committee believes that it would be appropriate to clarify that a transaction's material economic terms be subject to negotiation, rather than actually individually negotiated. What is relevant in distinguishing a standardized contract from a non-standardized contract is whether the parties have the ability to vary the terms, not whether the parties in fact do so in a particular case. Requiring the terms themselves to be actually individually negotiated is unnecessary and leads to uncertainty about whether a particular transaction has been or has not been sufficiently tailored.

The proposed revisions would also eliminate the requirement that a transaction only be terminable with counterparty consent and generally be expected to be maintained until maturity. This requirement has been the source of considerable uncertainty about whether and to what extent parties may agree in advance as to the early termination of transactions entered into between them. Although the Swap Policy Statement states that parties may individually negotiate termination provisions, this statement is not completely consistent with the overall requirement. The requirement has also created uncertainty as to the availability of the Swap Policy Statement for swap transactions used to hedge assets or liabilities that change or fluctuate over time. In any event, the Committee believes that the principal goal of the existing requirement, that transactions not be subject to exchange-style offset, would adequately be addressed by the requirement that transactions not be submitted for clearing.

Finally, the Committee believes that, consistent with the other changes to Part 35, it should be sufficient, as an alternative to the existing line of business test, that the parties to the

transaction be eligible participants or enter into the transaction to manage the risk associated with an asset or liability. As an initial matter, the existing "line of business" test, in the Committee's experience, has never been an appropriate or workable standard when applied in the context of swaps involving securities and capital market participants. The eligible participant standard has been effective in precluding public participation in the OTC derivatives market in connection with transactions entered into in reliance on the Existing Swap Exemption, and there is no reason to believe it would not serve equally well in this context. The "risk management" alternative would provide helpful clarification to the line of business test, which has been difficult to apply in the context of certain categories of market participants for which a "line of business" may be difficult to ascertain.

The proposed modifications to the Swap Policy Statement would be consistent with the proposed changes in the Part 35 exemption and would reflect the experience of market participants with the Swap Policy Statement since its adoption. Absent legislation relating to the status of equity derivatives, such a revised policy statement would play an essential role in enhancing the legal certainty of an important sector of the OTC derivatives market. In addition, it would augment significantly the effectiveness of the nonrepudiation provisions in proposed Rule 35.3(c) by making its protections available to a broader range of transactions.

(ii) **Hybrid Instruments**.

The market for hybrid instruments has, since the adoption of the Hybrid Interpretation, developed into one of the largest components of the derivatives markets. This has been particularly true with respect to hybrid instruments linked to the price of one or more equity or debt non-exempt securities. Unfortunately, the Hybrid Interpretation has not kept pace with these developments and has become difficult to apply in the context of many such instruments.

A particular problem relates to the requirement that the instrument have a commodity independent yield at the time of issuance of between 50% and 150% of the yield of a comparable non-hybrid instrument of the same maturity of the same issuer. As an initial matter, the Committee questions whether this test is necessary. The yield on a hybrid instrument will be determined as an economic matter by the cost of funds for the issuer, the net carrying cost associated with any embedded forward position or the implied premium of any embedded option position, and the costs of structuring and issuing the instrument. No additional yield constraint should be required.

In addition, in the Committee's view, the economic constraints created by the requirements that no additional payments be required of the holder of the hybrid instrument and that the hybrid instrument be indexed on no greater than a one-to-one basis are sufficient to ensure that the position is economically equivalent to a cash market position, as opposed to a futures contract or commodity option.

If the CFTC nonetheless intends to retain the 50%/150% test, the Committee believes that for hybrid instruments linked to the value of equity securities, issuers should be permitted to make the relevant comparison based on the dividend yield on the underlying security, as an alternative to the yield on a comparable non-hybrid instrument. This approach would reflect more closely the underlying economics of equity-linked hybrid instruments and

eliminate the need for issuers to try to create artificially commodity independent yield that serves no economic purpose other than satisfying the requirements of the Hybrid Interpretation.

In connection with notes linked to the value of indebtedness of another issuer of lower credit quality, such as certain credit-linked notes, the issuer of the hybrid instrument should be permitted to take into account the creditworthiness of the issuer of the underlying security and its corresponding higher cost of funds. The economic value of such an instrument, and the appropriate yield on the instrument as a commercial matter, will depend on the risk that the underlying security will default. In the same manner that the existing Hybrid Interpretation takes into account relative interest rates in computing the commodity independent yield of an instrument indexed to a foreign exchange rate, the commodity independent yield of a credit-linked note should be adjusted to reflect differences in creditworthiness between the issuers of the hybrid instrument and of the reference indebtedness.

Modifications of this sort would more easily accommodate the growing use of equity-linked and credit-linked hybrid instruments, which have features that were not entirely anticipated at the time the Hybrid Interpretation was issued and which have strained the limits of the existing Hybrid Interpretation. As with the suggested modifications to the Swap Policy Statement, these revisions would also enable market participants to realize more completely the benefits of the nonrepudiation provision in proposed Rule 35.3(c).

B. Government Securities.

The Committee believes that the CFTC should supplement the Proposed Rules by clarifying the status of futures transactions involving government securities and foreign currency under both the Treasury Amendment and the proposed Part 36 exemption for transactions on an MTEF.

(i) The Treasury Amendment.

The Committee suggests that the CFTC, in consultation with the Department of the Treasury, Federal Reserve Board and Securities and Exchange Commission, establish, by interpretation or exemption, a safe harbor from the requirements of the CEA for transactions involving government securities, foreign currency and the other products enumerated in the Treasury Amendment, consistent with the recommendations of the President's Working Group Report. By clarifying the scope of the Treasury Amendment exclusion for government securities in particular, such a safe harbor would facilitate the continued growth of institutional derivatives markets involving these products, a goal consistent with the underlying purpose of the Treasury Amendment and the recommendations of the President's Working Group.

(ii) Government Securities Transactions on MTEFs.

In the proposing release for Part 36, the CFTC requests comment as to whether permitting transactions involving government securities to be conducted on an MTEF pursuant to proposed Part 36 would create "significant and undesirable opportunities for regulatory arbitrage" in light of the significant regulation of the government securities markets under the Government Securities Act of 1986 and other securities laws. SIA and the Committee strongly

believe that the possibility of such arbitrage is limited and, accordingly, that transactions involving government securities should be eligible for the Part 36 exemption.

As an initial matter, the Committee notes that there would be substantial overlap between the Part 36 exemption as it applies to transactions involving government securities and the existing exclusion from the CEA provided by the Treasury Amendment. There would be no significant risk of regulatory arbitrage for transactions in this category, as the CEA's exclusive jurisdiction provisions would not apply, and such transactions would thus be subject to regulation under applicable securities laws.

If, however, the CFTC believes that there is a significant gap between the scope of the Treasury Amendment and the scope of the proposed Part 36 exemption as it applies to government securities transactions, the Committee believes that there are alternatives to excluding government securities transactions entirely from Part 36. One option would be to limit the class of persons eligible to act in a brokerage capacity in connection with such transactions, such as to banks (including foreign banks), broker-dealers and government securities broker-dealers. Limiting such an agency function to entities whose activities are subject to government oversight and regulation should substantially reduce the risk of regulatory arbitrage in connection with government securities transactions, even in an otherwise unregulated market.

II. **Revised Part 35 Exemption**.

As noted above, the Committee strongly endorses the revisions to Part 35 proposed by the CFTC, which would, among other changes, (i) promote the use of clearing facilities for OTC derivatives, (ii) promote the use of electronic technology in connection with the negotiation and execution of OTC derivatives, (iii) eliminate the requirement that a covered transaction "not be part of a fungible class of agreements that are standardized as to their material economic terms", and (iv) eliminate uncertainty as to the scope of the "swap agreement" definition. To further these goals and to take into account other aspects of the development of the OTC derivatives markets, the Committee also recommends that the CFTC consider the additional proposed modifications set forth below.

A. **Definition of Eligible Participant**.

The Committee believes that the categories of eligible participants should be expanded in a manner that reflects the increasingly diverse participation of financial institutions in OTC derivatives activities. Specifically, the Committee suggests the following revisions:

- Material Associated Persons. 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 (the "Exchange Act") and affiliated persons of registered FCMs for which the FCM makes and keeps records under Section 4f(c)(2)(B) of the CEA should be included as eligible participants. Such affiliates play a significant role in OTC derivatives activities of many financial institution groups and, in light of their indirect supervision by the SEC and the

CFTC, should be characterized as eligible participants without regard to the asset tests in the general corporation category of eligible participant.

- Foreign banks. The bank category should expressly include foreign banks and agencies and branches of foreign banks to remove any uncertainty as to their status under the proposed definition, which refers only to banks and trust companies.

- Holding Companies. In the wake of the changes to banking and securities laws under the Gramm-Leach-Bliley Act, financial holding companies (as defined in Section 2 of the Bank Holding Company Act of 1956) and investment bank holding companies (as defined in Section 17(i) of the Exchange Act) should be considered eligible participants.

- Insurance Company Affiliates. The insurance company category should be clarified to cover foreign- as well as state-regulated insurance companies and expanded to include their similarly regulated subsidiaries and affiliates, through which many insurance companies conduct their OTC derivatives activities.

- Individuals. In addition to natural persons with total assets in excess of $10 million, natural persons with total assets in excess of $5 million who enter into a particular 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 should be treated as eligible participants. In the Committee's view, this change, in addition to providing greater legal certainty, would likely result in dealers making risk management transactions available to a wider range of individuals. Nothing in the history of the application of the existing $10 million standard suggests that such an expansion of the class of eligible participants would lead to significant abuses. In addition, the Committee notes that a similar distinction is drawn in the general corporation category, where entities have a reduced financial requirement if entering into a transaction for hedging or other business purposes.

In addition, the Committee recommends that the CFTC clarify, either in the text of the proposed rule or the preamble, that the requirements of Rule 35.2(a) would be satisfied in circumstances where a party reasonably believes, at the time of entry into the relevant transaction, that its counterparty is an eligible participant.

B. **Agency Transactions**.

Proposed Rule 36.2(a) covers transactions by an eligible participant for its own account or on behalf of another eligible participant. The Committee believes that the same rule should apply to transactions under revised Part 35. In short, if an agency transaction is permissible under Part 36, it should also be permissible under Part 35. Any specific limitations

on agency transactions should be set forth in the operative provisions of the rule rather than stated or implied in the definitions of various categories of eligible participant.

C. **Creditworthiness**.

Revised Part 35 would retain the requirement from the Existing Swap Exemption, in cases where a transaction is not submitted for clearing, that the creditworthiness of the potential counterparty be a material consideration in entering into the transaction. This requirement was imposed in the Existing Swap Exemption principally as a means of prohibiting the clearing of swap agreements. Given that the CFTC has decided, consistent with the recommendations of the President's Working Group Report, to authorize expressly, and even to encourage, the clearing of OTC derivatives, this requirement is no longer appropriate. Retaining the requirement where transactions are not submitted for clearing is likely only to create further uncertainty and confusion as to what types of non-cleared transactions are permissible. In particular, the requirement may cause market participants to limit their use of collateral and other bilateral credit support mechanisms that would otherwise contribute to the reduction of systemic risk.

Accordingly, the Committee believes that the relevant provisions of Part 35 should follow the approach set forth in proposed Part 36, which requires only that if a covered transaction is submitted for clearing, it must be submitted to a clearing organization authorized under Part 39. The Committee requests that proposed Rules 35.2(c) and 35.2(d)(3) be modified accordingly.

D. **MTEF Definition**.

The revised definition of MTEF in proposed Rule 36.1 marks a significant improvement over the definition in the preamble to the Existing Swap Exemption, which has been a source of uncertainty and confusion for OTC derivatives market participants. The Committee endorses the CFTC's decision to exclude explicitly from the definition of MTEF communications systems in which the execution of a transaction results from bilateral communications between the parties, rather than from the interaction of multiple orders in a predetermined, non-discretionary trade matching algorithm, as well as single market-maker systems where only a single firm acts as market maker and other participants may not accept bids and offers of non-market-maker participants. These changes will bring much-needed certainty to an area of rapid technological change and promote the use of electronic systems, other than full-fledged MTEFs, in the negotiation and execution of OTC derivatives.

Nonetheless, the Committee believes the definition could be clearer as to its treatment of so-called "credit-screened systems"—those systems which include a functionality that filters or screens the bids and offers displayed and actionable on the system based on the extent to which each potential participant to a transaction has determined to extend credit to a particular counterparty. Because the proposed rule defines an MTEF as a system on which bids and offers are open to multiple participants, rather than all participants, as under the Existing Swap Exemption, the definition creates the possibility that a credit-screened electronic trading facility could be treated as an MTEF. This would have the effect of making transactions on such a system ineligible for the Part 35 exemption and requiring them to comply instead with the Part

36 exemption, which authorizes transactions in a significantly narrower range of commodities than under Part 35. Unlike the other changes to Part 35, this result could narrow, rather than expand or clarify, the scope of the exemption.

The Committee believes that, following existing practice, credit-screened systems should not be regarded as MTEFs. Credit-screened systems in effect force participants to make individual determinations about the creditworthiness of potential counterparties and to negotiate individually the credit and other material economic terms of their relationship with such counterparties. Transactions on these systems thus more closely resemble Part 35-eligible transactions, including transactions executed through electronic systems expressly excluded from the MTEF definition in the Proposed Rules, than the types of transactions effected on fully anonymous matching systems contemplated by Part 36.

As a result, the Committee recommends that the MTEF definition specifically exclude electronic systems on which parties can enter into bilateral transactions and which incorporate electronic filters that prevent any such party from executing a transaction with another party unless each, prior to the execution of the transaction, has authorized the extension of credit to the other in an amount sufficient for the proposed transaction.

E. **Netting**.

Part 35 would usefully clarify that a transaction would not become ineligible for the exemption if it is subject to arrangements for the netting of payments or payment obligations. The Committee believes that this provision should be extended also to permit expressly the netting of deliveries or delivery obligations in connection with transactions pursuant to Part 35. Numerous categories of OTC derivatives transactions require or permit settlement by delivery, and there is no policy reason for excluding netting of such deliveries while permitting netting of payments. In addition, permitting such netting would be consistent with the goals of the CFTC and other regulators to reduce credit and related systemic risks for OTC derivatives.

F. **"Bilateral" Transactions**.

While referring to transactions covered by revised Part 35 as "bilateral" is useful shorthand for distinguishing such transactions from those on an MTEF, the Committee believes that the preamble to the rule should clarify that such references are not intended to create any additional requirement that the transaction be between two parties. The number of parties to a transaction under Part 35 should be irrelevant so long as the requirements of the exemption are satisfied with respect to the transaction and each party to it. In addition, the Committee recommends that the preamble indicate that the change in coverage of the exemption from "swap agreements" to any "contract, agreement or transaction" should not be construed as expanding the CFTC's jurisdiction.

III. Part 36 Exemption.

The Committee strongly endorses the CFTC's proposed Part 36 exemption, which would, for the first time, provide legal certainty with respect to transactions between eligible participants on an MTEF. The exclusion of such transactions from the Existing Swap Exemption has proven to be one of its most significant limitations and has created considerable uncertainty as to the status of electronic trading systems for OTC derivatives under U.S. law. The Part 36 exemption is thus an essential step in providing U.S. market participants the opportunity to develop such systems, which appear to be likely to play an increasingly important role in the continued evolution of the OTC derivatives market.

For the reasons stated above with respect to Part 35, the Committee also strongly supports the nonrepudiation provision in proposed Rule 36.3(b), which would prohibit a counterparty to a transaction on an MTEF pursuant to Part 36 from repudiating or otherwise recovering a payment under the transaction because of a failure to comply with the terms of the Part 36 exemption.

In addition to the Committee's comments above with respect to transactions involving government securities and with respect to the MTEF definition, the Committee requests that the CFTC consider the following additional recommendations:

A. Scope of Permissible Transactions.

In the Committee's view, the scope of permissible transactions on an exempt MTEF should be clarified and, in certain respects, expanded. As a general matter, the Committee believes that a transaction in any commodity not subject to a material risk of manipulation should be permitted on a Part 36-exempt MTEF, so long as the other conditions of the rule are satisfied. Such transactions, if they are conducted solely between eligible participants as required under Part 36, should not require the greater levels of regulation applicable to contract markets, recognized futures exchanges or derivatives transaction facilities.

At the very least, the CFTC should leave open the possibility of expanding the range of permissible underlying commodities to include other commodities determined by the CFTC not to be subject to a material risk of manipulation. The responsibility for such a determination could be delegated to appropriate CFTC staff to avoid the need for subsequent formal rulemakings on this issue. The Committee also believes that the CFTC should add to the commodities covered expressly by the proposed rule intangible commodities, such as telecommunications bandwidth, and macroeconomic measures, such as the consumer price index. Although it is possible that some of these commodities may be covered by other categories, such as the catch-all for economic measures beyond the control of the parties to the transaction, in the interests of legal certainty the Committee believes that the CFTC should be more specific in defining the scope of the exemption with respect to transactions involving these commodities.

B. **Transparency**.

Part 36 would require that if the CFTC determines that an MTEF "serves as a significant source of price discovery for an underlying commodity," the MTEF must disseminate on a daily basis trading volume, price ranges and other data "appropriate to that market" as provided in the CFTC's order. As an initial matter, the Committee believes that this requirement should not apply to transactions other than futures contracts and commodity options otherwise subject to the CEA. The Committee also believes the CFTC should clarify how this requirement would apply to MTEFs that are wholesale markets.

In certain types of trading facilities, access is limited to professional or wholesale market participants. Although these facilities may serve a price discovery function for these participants, they do not necessarily serve this function for end-users or the general public. As a result, trading data dissemination for such markets is typically restricted as a commercial matter to participants on that market. In the view of the Committee, an MTEF of this type operating pursuant to Part 36 should not be required to disseminate wholesale market prices to the general public.

The Committee thus recommends that the CFTC clarify that proposed Rule 36.2(g) would impose no such requirement, either in the rule itself or in the preamble.

C. **Netting**.

As suggested in connection with revised Part 35, the Committee believes the authorization for the netting of payments and payment obligations in connection with transactions conducted on an MTEF should also extend to the netting of deliveries and delivery obligations.

IV. **Part 39 Exemption**.

The Committee applauds the CFTC's proposal to permit the clearing of OTC derivatives transactions entered into in reliance on proposed Parts 35 and 36. Clearing of OTC derivatives will provide a key mechanism for limiting the credit and related systemic risks of transactions in the OTC derivatives market that have arisen as the size of the market has grown. It will accordingly enhance the soundness and efficiency of the U.S. OTC derivatives markets and make them better able to compete with markets in foreign jurisdictions where such clearing is already permitted.

Proposed Rule 39.2(b) would permit a transaction effected pursuant to Part 35 or Part 36 to be cleared by any of the following: a recognized clearing organization regulated by the CFTC, a securities clearing agency regulated by the Securities and Exchange Commission, a clearing organization organized as a bank or bank affiliate subject to the jurisdiction of the Federal Reserve or the Comptroller of the Currency, or a foreign clearing organization that is subject to comparable regulation in its home country and is a party to and abides by adequate information-sharing arrangements. This flexible approach recognizes that clearing activities for these types of transactions may be appropriately regulated by one of a number of different authorities. It would also permit existing clearing organizations regulated by these authorities

more easily to enter into the business of clearing OTC derivatives without requiring them to submit to oversight by an additional regulator.

The Committee would nonetheless request that the CFTC make the following additional modifications in preparing final rules:

A. Clearing of Other Transactions.

Part 39 should expressly permit a recognized clearing organization registered with the CFTC to clear transactions not subject to Part 39 or otherwise not subject to the CFTC's jurisdiction, including transactions effected pursuant to the Treasury Amendment (to the extent permitted by otherwise applicable law). This approach may facilitate cross-clearing of different types of related transactions, which can be an effective tool in reducing overall credit risk. Similarly, a clearing organization not necessarily required by Part 39 to register with the CFTC as a recognized clearing organization should be permitted to elect to do so.

B. Antifraud Provision.

The Committee does not believe that proposed Rule 39.6, which would prohibit fraud in connection with transactions cleared by a recognized clearing organization, is appropriate. The CFTC currently has antifraud authority under the CEA with respect to transactions on designated contract markets, and proposes to retain its antifraud authority under the CEA with respect to transactions on recognized futures exchanges and derivatives transaction facilities as well as transactions exempt pursuant to Parts 35 and 36. The CFTC does not need additional antifraud authority with respect to these transactions if they are submitted for clearing. Transactions that are not otherwise subject to the CEA's antifraud provisions should not become subject to the CFTC's antifraud authority solely by virtue of being cleared. As a general matter, the Committee believes fraud can best be combated in the facility where a transaction is executed, not in a clearing organization.

C. Bankruptcy Treatment.

The Committee agrees with the CFTC's goal that transactions cleared by a clearing organization should be afforded the same treatment under the Bankruptcy Code as transactions conducted on a contract market. The CFTC's approach to this issue in proposed Rule 39.1(b)(2), which would make all transactions effected pursuant to Parts 35 or 36 transactions conducted on a contract market, may have unintended consequences, however. In particular, regulated market participants, such as futures commission merchants, commodity trading advisers and commodity pool operators, might not be able to take full advantage of the exemptions otherwise available to them in connection with transactions not conducted on a contract market. This could put such entities at a disadvantage as compared to other market participants.

D. Application of Core Principles.

The core principles applicable to recognized clearing organizations appear generally to have been drafted with a focus on clearing organizations for contract markets, recognized futures exchanges and derivatives transactions facilities. The Committee believes the

core principles or the attached guidance should make clear that some of these principles may not be applicable for clearing organizations that limit their clearing activities to transactions exempt under Parts 35 and 36.

For example, the core principle relating to protecting client funds and property may not be relevant for principal-to-principal transactions exempt under revised Part 35. In addition, clearing organizations whose activities are limited to clearing OTC derivatives may not need to be party to information-sharing arrangements, at least not to the same extent as clearing organizations for contract markets, which may face additional customer protection and manipulation concerns.

V. Additional Comments.

The Committee generally supports the CFTC's efforts to provide regulatory relief with respect to futures exchanges, including by allowing the creation of less-regulated derivatives transaction facilities, and to provide corresponding relief with respect to the regulation of intermediaries that trade on those institutions. The Committee does not, however, intend to comment specifically on those provisions.

In addition, the Committee generally concurs with and endorses the comments submitted to the CFTC with respect to the Proposed Rules by the Ad Hoc Coalition of Commercial and Investment Banks and the International Swaps and Derivatives Association, Inc.

VI. Conclusions.

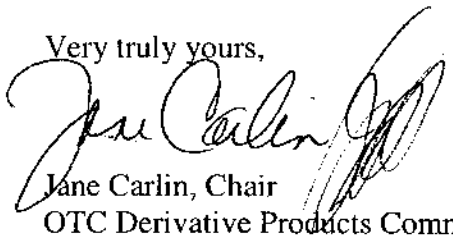
The Proposed Rules represent a significant step toward eliminating some of the legal uncertainties that have restricted the continued development of the OTC derivatives markets. The CFTC deserves credit for taking a novel and thoughtful approach to the resolution of these issues within the framework of its exemptive authority under Section 4(c) of the CEA. The Committee believes that the CFTC should adopt the Proposed Rules as expeditiously as possible, subject to the recommendations set forth herein.

Nonetheless, the Committee believes that there are important areas of legal uncertainty with respect to OTC derivatives that have not been addressed by the Proposed Rules, particularly in the case of transactions involving non-exempt securities. Although there are limitations on the CFTC's exemptive authority with respect to non-exempt securities, the CFTC could provide considerable assistance by updating and reissuing the Swap Policy Statement and the Hybrid Interpretation in a manner that resolves certain limitations of these interpretations. Similarly, the CFTC could bring additional certainty to the government securities markets by creating a safe harbor for transactions involving government securities subject to the Treasury Amendment. The Committee urges the CFTC to consider these additional issues, either as part of this rulemaking or in a separate initiative to follow as promptly thereafter as possible.

* * *

The Committee appreciates the opportunity to comment on the Proposed Rules and, as always, would be pleased to work with the CFTC and other interested parties to address the issues discussed herein. Please do not hesitate to contact the undersigned (212-762-7122) or the Committee adviser, Jerry Quinn (212-618-0507) or our counsel, Edward J. Rosen (tel. 212-225-2820) or Geoffrey B. Goldman (tel. 212-225-2234) of Cleary, Gottlieb, Steen & Hamilton if you have any questions regarding this letter.

Very truly yours,



Jane Carlin, Chair
OTC Derivative Products Committee

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