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April 9, 2001

Commodity Futures Trading Commission
Three Lafayette Center
1155 Twenty First Street, N.W.
Washington, D.C. 20581

Attention: Office of the Secretariat

Re: Regulatory Reinvention

Ladies and Gentlemen:

This letter contains the comments of the International Swaps and Derivatives Association, Inc. ("ISDA) on proposed regulations issued by the Commodity Futures Trading Commission (the "Commission") to implement the Commodity Futures Modernization Act of 2000 (the "CFMA"). The proposed regulations provide rules applicable to trading facilities and were published in the Federal Register for March 9, 2001 (66 Fed. Reg. No. 47 at 14262 et seq.).

ISDA is an international organization and its more than 500 members include the world's leading dealers in swaps and other off-exchange derivatives transactions (collectively "OTC derivatives transactions"). ISDA's dealer-members are among the principal users of the futures exchanges that are regulated by the Commission under the Commodity Exchange Act (the "CEA"). ISDA's members also 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.

ISDA welcomes the decision of the Commission to proceed promptly with its regulatory initiative to implement the landmark CFMA. As noted by the Commission in the Preamble to the proposed regulations, the CFMA codifies in many key respects the elements of the "New Regulatory Framework" adopted by the Commission on its own initiative in December 2000 prior to enactment of the CFMA.

Effect of the CFMA on Scope of the New Regulatory Framework

A major goal of Congress in enacting the CFMA was to provide legal certainty with respect to the status of OTC derivatives transactions under the CEA. This was accomplished by the enactment of a series of statutory exclusions and exemptions from the CEA, as well as provisions prohibiting the use of asserted failures to comply with the CEA (or rules and regulations thereunder) by parties to OTC derivatives transactions as a basis for abrogating otherwise binding contractual obligations. As a result of these amendments to the CEA, many of the provisions of the original new regulatory framework adopted by Commission in December 2000 and applicable to OTC derivatives transactions have been rendered unnecessary. ISDA welcomes the decision of the Commission, as reflected in the proposed regulations, generally to permit the new statutory provisions providing legal certainty to "speak for themselves". This approach will, in ISDA's view, best promote legal certainty with respect to the status of all OTC derivatives transactions.

Designated Contract Markets

Despite the enactment of the legal certainty provisions of the CFMA, ISDA and its members have a substantial and continuing interest in the activities of the Commission and in the substantive provisions of the proposed regulations with respect to trading facilities. As noted, ISDA's dealer-members are among the principal users of the futures exchanges (denominated as "designated contract markets" under the CFMA and the proposed regulations). Those markets should, in ISDA's view, be supervised by the CFTC in a manner that will both promote financial innovation, through the development of new exchange-traded contracts and otherwise, and enable these markets to reduce transaction costs to levels that will enhance their ability to compete effectively in the global financial markets.

In ISDA's view, the portions of the proposed regulations that are applicable to designated contract markets are generally structured to create the environment necessary to enable these markets to achieve the objectives outlined above. The Commission and its professional staff are to be commended for the manner in which they have endeavored to carry out the intent of Congress with respect to the transformation of the Commission from a front-line regulator to an oversight agency charged with protecting the public interest in a manner that will enable the futures exchanges to innovate and compete effectively.

Registered Derivatives Transaction Execution Facilities

ISDA and its members likewise have a substantial interest in that portion of the proposed regulations (Part 37) applicable to derivatives transaction execution facilities (commonly referred to as "DTFs"). Under the CFMA, OTC derivatives transactions involving certain underlying commodities that are effected on an electronic trading facility may not be within the scope of the various statutory exclusions or exemptions (or the Swaps Exemption, when it is republished). The use of electronic trading systems is desirable as a matter of public policy as these systems promote financial innovation, efficiency and transparency and some of these facilities may wish to register as a DTF.

ISDA is pleased that the DTF portion of the proposed regulations generally incorporates views previously expressed by ISDA. For example, the proposed regulations would permit an applicant to become registered as a DTF without *demonstrating* its capacity to comply with the core principles for trading so long as the applicant *certifies* to the Commission that it has the capacity to, and upon commencing operations will in fact, operate in compliance with those core principles. This approach conforms with section 5(c) of the CEA and reflects once again the welcome decision of the Commission and its staff to implement the CFMA in a manner the minimizes unnecessary regulatory burdens and thus promotes economic efficiency.

Proposed regulation section 37.3(a)(1)(iv) indicates that underlying commodities which are "excluded commodities" under section 1a(13) of the CEA meet the requirements for trading on a DTF. As noted in the Preamble to the proposed regulations, this term includes exempt securities and the CFMA imposes no limitations or requirements for exempt securities to trade on a DTF. The Preamble also requests comments on whether the Commission should impose additional regulatory requirements, such as large trader reporting, as a condition for trading exempt securities on a DTF. In principle, ISDA has no objection to the imposition of reasonable regulatory requirements where a compelling public interest supports such requirements. ISDA does believe, however, that the Commission should only do so where the public interest considerations are in fact compelling. Otherwise, the DTF mechanism could become sufficiently encumbered with non-statutory requirements that its practical utility to, and use by, the private sector will be materially reduced. Moreover, ISDA believes that the imposition of any such requirements should occur only as the result of a process that provides an opportunity for public comment and that any such requirements should be imposed only a prospective basis.

Proposed regulation section 37.3 also indicates that the Commission has determined to defer the enumeration of other categories of underlying commodities with respect to which DTF trading should be permitted when access is not limited to eligible commercial entities. While ISDA recognizes that the Commission and its staff have a broad range of matters that require attention in order properly to implement the CFMA and the new regulatory framework, it is important that the Commission, as part of this rule making process, indicate its intention to act with dispatch in this area, particularly with respect to energy and metals transactions. The Commission could accomplish this objective by including statements to that effect in the Preamble to the final regulations. The Commission should also consider inserting a general timetable for action in proposed regulation section 37.3(a)(3)(ii), which provides a process for private sector requests for individualized determinations by the Commission that contracts based on a particular commodity should be designated as eligible for trading on a DTF on a non-exclusive basis. Finally, the petitions to be filed by a DTF pursuant to proposed regulation section 37.3(a)(3)(ii) may prove to be unnecessarily time-consuming and cumbersome in practice. ISDA would recommend that information of the types described be supplied when requested by the Commission in response to a petition under that provision. Consistent with the foregoing, the Commission should move with dispatch to implement section 5(e)(2) of the CEA, which authorizes the Commission to designate certain agricultural commodities as eligible for trading on a DTF.

Proposed regulation section 37.9 implements the policy underlying section 22(a)(4) of the CEA with respect to contract enforcement involving DTF transactions. ISDA believes the initial clause of this portion of the proposed regulations should be revised to parallel more directly the language of the statute itself. As so revised, the initial clause of proposed regulation 37.9 would provide as follows:

> "An agreement, contract or transaction entered into on, or pursuant to, the rules of a registered derivatives transaction execution facility shall not be void, voidable, or unenforceable, and no party shall be entitled to rescind, or recover any payment with respect to, such an agreement contract or transaction under this section or any other provision of Federal or State law, based solely on. . . ."

A comparable change should be made to section 38.6 of the proposed regulations.

<u>Exempt Markets</u>

Proposed regulation Part 36 is intended to implement those portions of the CFMA that authorize two categories of markets that are exempt from regulatory oversight by the Commission: exempt commercial markets and exempt boards of trade. ISDA and its members have an interest in ensuring that these exemptions function properly and contribute positively to both legal certainty and financial innovation.

If these objectives are to be achieved, the proposed regulations must be structured in a manner that will not create any inference that the underlying contracts are otherwise subject to the Commission's jurisdiction. ISDA is pleased that, in implementing these statutory exemptions, the Commission generally did not seek to subject transactions on exempt commercial and exempt boards of trade to non-statutory rules (such as a special antifraud 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 transactions under the CEA.

In contrast to the DTF proposed regulations, section 36.2 of the proposed regulations defines the commodities that are eligible to be traded on an exempt board of trade as encompassing (1) all "excluded commodities" under section 1a(13) of the CEA *other than* securities, and (2) such other commodities as the Commission may designate in the future. As noted above, ISDA recognizes that the Commission and its staff have a broad range of matters that require attention in order properly to implement the CFMA and the new regulatory framework. As in the case of DTFs, however, ISDA believes it is important that the Commission indicate its intention to act with dispatch in designating additional commodities that may be traded on an exempt board of trade. Any such designation should be done on a non-exclusive basis.

The proposed regulations prohibit exempt commercial markets and exempt boards of trade from representing that they are registered with, designated, recognized, licensed or approved by the Commission. The Preamble to the proposed regulations invites comment on whether these exempt entities should be required affirmatively to disclose that they are *not* regulated or approved by the Commission. ISDA believes such a requirement is unnecessary and inappropriate. Both of these exempt markets generally are limited to transactions involving sophisticated counterparties and there is no demonstrable reason to suggest they need special disclosures of the type banks are required to make when seeking to provide, say, investment services or insurance products to individual depositors. Should the Commission elect to publish lists of facilities that have notified the Commission of their intent to operate as exempt markets, it could of course incorporate such a disclaimer in its publication.

<u>Anti-Fraud Provisions</u>

The proposed regulations provide for the adoption of an anti-fraud rule which, as described in the Preamble, is intended to implement Congressional intent with respect to ". . .certain retail foreign exchange transactions and bucket shops that may not otherwise be regulated". This rule, proposed section 1.1, would be in addition to the other existing anti-fraud rules promulgated by the Commission.

Under the proposed regulation, the anti-fraud rule would not be applicable to transactions involving persons described in section 2(c)(2)(B)(ii)(I) or (II) of the CEA (i.e., broker-dealers, FCMs and their respective affiliated persons). In ISDA's view this exclusion should be expanded to encompass transactions involving any of person described in section 2(c)(2)(B)(ii). This would extend the exclusion to include transactions involving financial institutions, insurance companies, financial holding companies and investment bank holding companies. Transactions involving any of the categories of persons were excluded by Congress from the category of retail foreign currency transactions that to be regulated by the Commission.

In connection with the foregoing, ISDA notes that Commissioner Erickson, in his Concurring Statement, expressed the belief that ". . . it is in the public interest to propose a more comprehensive antifraud rule" and questioned why, as some apparently have asserted, such a comprehensive rule ". . . in any way violates the public interest, overrides the intent of Congress, or oversteps the Commission's authority." 66 Fed. Reg. No. 47 at 14289.

In ISDA's view, the Commission is free under the CEA, as amended by the CFMA, to adopt whatever anti-fraud rules it concludes are required by the public interest, but only if the scope of the rule is circumscribed by the scope of the Commission's jurisdiction. At the same time, however, past experience suggests that the Commission must be vigilant in structuring any such rules to avoid creating any uncertainty with respect to the views of the Commission as to the scope of its jurisdiction. Thus, any such rule must be *explicitly* limited to those transactions that are in fact otherwise subject to the Commission's jurisdiction.

The anti-fraud rule contained in the proposed regulations accomplishes this objective because it is explicitly limited to those transactions as to which the Commission has jurisdiction under section 2(c)(2)(B) of the CEA. In contrast, the general reference to anti-fraud proceedings in the Swaps Exemption (Part 35) had the potential to create legal *uncertainty* (i.e., by suggesting that transactions covered by that self-executing exemption might be considered by the Commission as within its jurisdiction since the Commission could not otherwise lawfully exercise the anti-fraud authority referred to in Part 35). These concerns prompted the Commission not to propose a free-standing anti-fraud rule for exempt boards of trade in its 2000 New Regulatory Framework and those concerns should continue to be paramount in the Commission's deliberations on this subject.

The Commission should likewise adhere to the findings of the President's Working Group on Financial Markets, as set forth in its November 1999 report on OTC derivatives under the CEA, that the sophisticated counterparties (now commonly referred to as eligible contract participants) simply do not need special consumer protections. Thus, while the Commission may have authority to promulgate a "comprehensive" anti-fraud rule applicable only to transactions otherwise within its jurisdiction, it should consider doing so only if it (1) explicitly limits the rule to those classes of participants who in fact need special consumer protections and (2) affirmatively determines that other applicable laws and regulations (including those applicable to the dealers involved in those transactions) are plainly inadequate to provide those protections. ISDA does not believe that there is a basis for any such determination at this time.

Conclusion

As stated at the outset of this letter, ISDA welcomes the issuance of the proposed regulations. While ISDA believes the proposed regulations should be modified in certain respects, the Commission and its professional staff deserve great credit for both the substantive terms proposed regulations and the consultative process by which they were developed. ISDA and its members have appreciated the opportunity to work with Acting Chairman Newsome, the other members of 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,

Robert G. Pickel

Robert Pickel
Chief Executive Officer
and Executive Director