MEMORANDUM FOR ISDA MEMBERS

COMMODITY FUTURES MODERNIZATION ACT OF 2000

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The Commodity Futures Modernization Act of 2000 (H.R. 5660) (the "Act") was signed into law by President Clinton on December 21, 2000.[1] The Act represents a sweeping overhaul of the provisions of the Commodity Exchange Act (the "CEA").

The Act addresses uncertainties regarding the status of over-the-counter ("OTC") derivatives and hybrid instruments under the CEA through a number of statutory exclusions and exemptions. The Act also addresses uncertainties regarding the status of certain non-retail swaps under the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act") by clarifying that while such swaps are not securities under those statutes, specific fraud, manipulation and insider trading prohibitions nevertheless apply to certain security-based swap agreements. This Memorandum will concentrate on the foregoing aspects of the Act.

The Act also restructures the regulation of exchange-traded futures contracts under the CEA. In addition, the Act permits, for the first time, the trading in the United States of futures contracts on individual equity securities and narrow groups and indices of such securities. Finally, the Act authorizes the clearing of OTC derivatives and establishes a framework for the regulation

[1] The Act was passed as part of H.R. 4577, the Consolidated Appropriations Act, 2001.

of clearing organizations. These aspects of the Act will be summarized at the end of this Memorandum.

The Commodities Futures Trading Commission (the "CFTC") approved rules consisting of four separate releases on November 22, 2000, that contained many provisions similar to the provisions of the Act. In a release issued on December 21, 2000, and effective as of December 28, 2000, the CFTC withdrew almost all the new rules as a result of the enactment of the Act.

I. Executive Summary

The key provisions of the Act from the point of view of OTC derivatives include the following:

1. Legal Certainty.

Concerns about the enforcement of OTC derivatives transactions due to the exchange-trading requirement of the CEA have been fully put to rest. Under the Act, no contract shall be unenforceable under the CEA or any other provision of Federal or State law based on a failure to comply with any exemption or exclusion from any provision of the CEA.

2. OTC Derivatives.

The Act excludes from the coverage of the CEA and regulation by the CFTC a broad range of swap agreements and other OTC derivatives that are not executed on a trading facility.

- Transactions involving any commodity (other than an agricultural commodity) that are not executed on a trading facility are excluded from the CEA if they are entered into solely by eligible contract participants[2] and are subject to individual negotiation.
- Also excluded from the CEA are transactions involving "excluded commodities" (a broad range of interest rate, currency, credit, equity, weather and other derivatives, but not energy products, chemicals or metal derivatives) that are not executed on a trading facility and are entered into solely by eligible contract participants.
- Transactions involving "exempt commodities" (commodities other than excluded commodities or agricultural commodities, but including commodities such as energy products, chemicals and metals) are

[2] The Act's definition of "eligible contract participant" is based upon the CFTC's definition of "eligible swap participant" in the 1993 Swaps Exemption, but, as explained below, it has been expanded in several respects.

similarly excluded from the CEA, but remain subject to the CFTC's antifraud and antimanipulation jurisdiction.

The Act also provides exclusions for transactions entered into through electronic trading facilities.

- The Act excludes from the CEA any transaction involving an excluded commodity that is executed through an electronic trading facility by eligible contract participants trading on a principal-to-principal basis or by certain authorized fiduciaries or investment managers.
- The Act also provides an exclusion for any transaction involving an exempt commodity that is executed through an electronic trading facility by certain commercial entities trading on a principal-to-principal basis. Such transactions will be subject to the CFTC's antifraud and antimanipulation authority, and the facility will be subject to certain recordkeeping, price dissemination, reporting and related requirements.

In addition, the Act creates, as part of the separate "Legal Certainty for Bank Products Act of 2000", an exclusion from the CEA for certain individually negotiated swap agreements offered by banks to eligible contract participants.

3. <u>Hybrid Instruments.</u>

The Act excludes from coverage of the CEA and regulation by the CFTC hybrid instruments that are "predominantly" securities. A hybrid instrument is "predominantly" a security for these purposes if the issuer receives full payment of the purchase price substantially contemporaneously with delivery, the holder is not required to make any additional payments to the issuer, the issuer is not subject to mark-to-market margining requirements and the instrument is not marketed as a futures contract (or option thereon).

The Act also adds, as part of the separate Legal Certainty for Bank Products Act of 2000, a parallel exclusion from the CEA for hybrid instruments that are predominantly identified banking products.

4. <u>Treasury Amendment.</u>

The Act amends the "Treasury Amendment" to exclude from the CEA transactions involving foreign currency, governmental securities, security warrants, security rights, resales of installment loan contracts, repurchase transactions in "excluded commodities" or mortgages or mortgage purchase commitments that are not futures contracts (or options thereon) or commodity options conducted on "organized exchanges". An "organized exchange" is defined as a trading facility that permits trading by or on behalf of a person that is not an eligible contract participant or by persons other than on a principal-to-principal basis, or that has adopted rules that govern the conduct of certain participants and provide disciplinary sanctions.

The Act grants jurisdiction to the CFTC over foreign currency futures contracts or options (other than options traded on a national securities exchange) entered into with persons that are not "eligible contract participants", unless the relevant dealer is one of an enumerated group of regulated entities.

5. Treatment of Swaps under the Securities Laws.

The Act amends the 1933 Act and the 1934 Act to provide that swap agreements, whether or not based on securities prices, yields or volatilities, are not securities under those statutes.

- Swap agreement is defined broadly for this purpose with respect to transactions that are between eligible contract participants and the material economic terms of which are subject to individual negotiation.

- Swap agreements that are based on securities prices, yields or volatilities are, however, subject to specific antifraud, antimanipulation and anti-insider trading provisions of the 1933 Act and 1934 Act.
- The SEC nevertheless may neither require the registration of securities-based swap agreements nor promulgate or enforce rules or orders that impose reporting or recordkeeping requirements or other procedures or standards as prophylactic measures against fraud, manipulation or insider trading with respect to securities-based swap agreements.

6. Clearing.

The Act permits clearing of OTC derivatives transactions without disqualifying those transactions from any of the exclusions discussed above. The Act requires, however, that clearing of excluded OTC derivatives transactions occur through a clearing organization regulated by the SEC, the CFTC or the Federal banking regulators.

II. Background

The CEA was signed into law in 1974. Until amended by the Act, the CEA required that futures contracts be traded on a regulated exchange. A futures contract traded off an exchange was illegal and unenforceable. In

1974 this draconian standard was sensible because the meanings of "futures" and "exchanges" were reasonably clear in view of the types of transactions and trading systems in existence at that time. The development of OTC derivatives transactions since the early 1980's reduced this clarity and led to concerns about the enforceability of certain derivatives transactions under the CEA.

The CFTC mitigated this uncertainty when it issued the Swaps Policy Statement in 1989. The uncertainty was further reduced with the passage in late 1992 of the Futures Trading Practices Act and the related adoption by the CFTC of the Swaps Exemption in early 1993. Concerns about enforceability remained, however, because the Swaps Exemption does not apply to securities-based derivatives (e.g., equity derivatives and certain credit derivatives). This limitation in the Swaps Exemption was due to the express requirements of the Futures Trading Practices Act. The enhanced popularity of securities-based derivatives since 1993 has increased the uncertainty that remained after the adoption of the Swaps Exemption. Moreover, the terms of the Swaps Exemption have become less useful over time as derivatives activities have evolved since 1993.

Certain actions by the CFTC also increased legal certainty concerns. The enforcement orders of the CFTC involving Bankers Trust Company (December 22, 1994) and MG Refining and Marketing, Inc. (July 27, 1995) suggested that the CFTC believed that at least some OTC derivatives constitute "futures". In 1998, the CFTC issued a concept release regarding OTC derivatives that was perceived by many as a precursor to regulating these transactions as futures. This created both regulatory and enforceability uncertainty. Congress responded by adopting a six-month moratorium on the CFTC's ability to regulate OTC derivatives in order to give the President's Working Group on Financial Markets an opportunity to complete a study on the relevant issues. In November 1999 the President's Working Group completed its unanimous recommendations on OTC derivatives and presented its findings to Congress.[3] Those recommendations provided the foundations for the Act.

There also has been uncertainty about the status of OTC derivatives under the 1933 Act and the 1934 Act. The

[3] See Report of the President's Working Group on Financial Markets, "Over-the-Counter Derivatives Markets and the Commodity Exchange Act" (November 1999).

SEC's order imposing sanctions on Bankers Trust Company (December 22, 1994) used what many considered to be a broad definition of a "security" in order to assert regulatory jurisdiction in that situation. There also has been private litigation in the U.S. that has included broad assertions that OTC derivatives transactions constitute securities under the 1933 Act and the 1934 Act.

ISDA has been working to increase legal and regulatory certainty for OTC derivatives under the CEA since 1988. The passage of the Act represents the successful culmination of many years of work by ISDA and numerous other interested parties. It is also notable that the Act clarifies the status of OTC derivatives under the U.S. securities laws.

III. Definitions

Certain terms are fundamental to understanding the legal certainty provisions of the Act. A summary of the key terms is set forth below.

1. Agreements, Contracts or Transactions.

Numerous provisions of the Act apply to "agreements, contracts or transactions". The Swap Exemption adopted by the CFTC in 1993 applies to "swap agreements". Clearly, the new exclusions in the Act no longer require that the subject transaction constitute a "swap agreement". This change to a more generic term eliminates any suggestion that there is a separate requirement that a transaction meet some test of being a certain type of agreement before being excluded from the CEA. References to "any transaction" or "transactions" in this Memorandum should be understood as references to "any contract, agreement or transaction" or "contracts, agreements or transactions".

2. Eligible Contract Participant.

Several sections of the Act condition an exclusion or an exemption on the requirement that a transaction involve "eligible contract participants". The term "eligible contract participant" should include all derivatives dealers that are ISDA members and most of their counterparties. The term "eligible contract participant" is broader than "eligible swap participant" in the CFTC's 1993 Swaps Exemption in several respects. First, "eligible contract participant" includes natural persons with more than $5,000,000 in assets who enter into the related transaction for risk management purposes. It also includes non-U.S. regulated insurance companies and regulated insurance company affiliates as well as non-U.S. banks and their U.S. branches and agencies. Finally, "eligible contract participant" includes certain eligible contract participants acting as brokers, agents, investment advisors or fiduciaries. "Eligible contract participant" in relevant part includes:

(A) acting for its own account--

(1) a financial institution (any U.S. depository institution, any non-U.S. bank or U.S. branch or agency of a non-U.S. bank, any financial holding company or any trust company);

(2) an insurance company regulated by a State or subject to similar non-U.S. regulation, including regulated affiliates;

(3) a U.S. regulated investment company or a non-U.S. entity subject to similar regulation;

(4) a corporation, partnership or other entity that has total assets in excess of $10,000,000;

(5) an ERISA employee benefits plan that has total assets in excess of $5,000,000;

(6) a registered broker-dealer or a broker-dealer subject to similar non-U.S. regulation;

(7) an individual with total assets in excess of $10,000,000 (or in excess of $5,000,000 and who enters into the transaction for risk management purposes);[4]

(B) an eligible contract participant described in (a)(1), (2), (4) or (6) above or in (C) below when acting as a broker or performing a similar agency function on behalf of any other eligible contract participant; or

(C) a registered investment advisor, a registered commodity trading advisor (or, in either case, a non-U.S. person subject to similar regulation) or an eligible contract participant described in (A)(1), (2), (4) or (6) above when, acting as an authorized investment manager or fiduciary.

The distinction made in (B) and (C) above is relevant to the exclusion for transactions in an excluded commodity executed on an electronic trading facility in new

[4] The definition of "eligible contract participant" also covers material associated persons of broker-dealers, futures commission merchants, floor brokers, floor traders, governmental entities and commodity pools.

Section 2(d)(2) of the CEA, which is available if the transaction either is entered into on a principal-to-principal basis or as described in (C) above (but not in (B) above). See part V.2 below.

3. <u>Trading Facility and Electronic Trading Facility.</u>

The terms of several exclusions and exemptions also vary depending on whether or not a contract, agreement or transaction is executed or traded on a "trading facility" or an "electronic trading facility". The Act defines "trading facility" as follows:

> **"(A) IN GENERAL. The term 'trading facility' means a person or group of persons that constitutes, maintains, or provides a physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements, contracts, or transactions by accepting bids and offers made by other participants that are open to multiple participants in the facility or system.**
>
> **(B) EXCLUSIONS. The term 'trading facility' does not include--**
>
> > **(i) a person or group of persons solely because the person or group of persons constitutes, maintains, or provides an electronic facility or system that enables participants to negotiate the terms of and enter into bilateral transactions as a result of communications exchanged by the parties and not from interaction of multiple bids and multiple offers within a predetermined, nondiscretionary automated trade matching and execution algorithm;**
> >
> > **(ii) a government securities dealer or government**

> securities broker, to the extent that the dealer or broker executes or trades agreements, contracts, or transactions in government securities, or assists persons in communicating about, negotiating, entering into, executing, or trading an agreement, contract, or transaction in government securities . . .; or
>
> (iii) facilities on which bids and offers, and acceptances of bids and offers effected on the facility, are not binding.
>
> Any person, group of persons, dealer, broker, or facility described in clause (i) or (ii) is excluded from the meaning of the term 'trading facility' for the purposes of this Act without any prior specific approval, certification, or other action by the Commission."

Speaking in the Senate on December 15, 2000, Senator Lugar, Chairman of the Senate Agriculture Committee, further clarified the definition of a 'trading facility' by explaining that such exclusion attempts:

> ". . . to address the advent of electronic trading and the changing and innovating nature of the financial industry. Indeed, we are keenly aware that there are newly emerging electronic systems that provide for the electronic negotiation of swaps agreements between and among large banks and other sophisticated major financial institutions acting as dealers. We do not intend for these systems to come within the definition of trading facilities." 146 Cong. Rec. S11925 (2000).

Congressman Leach, Chairman of the House Banking Committee, made a similar point in a Floor Statement released on December 15, 2000. He stated that:

> "A final matter which deserves attention is the definition of 'trading facility' contained in

> section 103 of the legislation. Whether an entity is a 'trading facility' has ramifications as to whether or not the entity might be regulated by the CFTC and/or the SEC. It should be made clear that the definition of 'trading facility' is not to be construed so broadly as to include existing and developing electronic systems which permit parties to negotiate and enter into over-the-counter derivatives transactions." Floor Statement of Congressman James A. Leach on the Commodity Futures Modernization Act (Dec. 15, 2000).

An "electronic trading facility" is defined in the Act as a "trading facility" that:

> "(A) operates by means of an electronic or telecommunications network; and
>
> (B) maintains an automated audit trail of bids, offers, and the matching of orders or the execution of transactions on the facility."

4. <u>Excluded Commodities and Exempt Commodities.</u>

New Section 2(d) of the CEA contains a broad exclusion for qualifying transactions in "excluded commodities". New Section 2(h) of the CEA contains a somewhat more narrow exclusion for qualifying transactions in "exempt commodities". While Congress wanted to provide significant relief for transactions involving all non-agricultural commodities, the enactment of more narrow relief for exempt commodities was due to concerns with possible manipulation of the market price of such commodities.

The term "excluded commodity" is defined to mean:

"(i) an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure;

(ii) any other rate, differential, index, or measure of economic or commercial risk, return, or value that is--

(I) not based in substantial part on the value of a narrow group of commodities not described in clause (i); or

(II) based solely on 1 or more commodities that have no cash market;

(iii) any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction; or

(iv) an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in clause (i)) that is--

(I) beyond the control of the parties to the relevant contract, agreement, or transaction; and

(II) associated with a financial, commercial, or economic consequence."

The term "exempt commodity" means a "commodity that is not an "excluded commodity" or an "agricultural commodity".

Many types of transactions entered into under ISDA Master Agreements involve excluded commodities. Examples include interest rate, currency, credit, equity and weather derivatives and transactions involving commodities having no cash market. Transactions involving metals, chemicals or energy products, however, will be considered transactions involving exempt commodities.

IV. <u>Contract Enforceability</u>

Concerns about the enforcement of OTC derivatives transactions due to the exchange trading requirement of the CEA have been fully put to rest. Section 22 of the CEA is entitled "Private Right of Action". The Act adds a new clause (4) at the end of Section 22(a), which provides as follows:

> "(4) CONTRACT ENFORCEMENT BETWEEN ELIGIBLE COUNTERPARTIES. No agreement, contract, or transaction between eligible contract participants or persons reasonably believed to be eligible contract participants, and no hybrid instrument sold to any investor, shall be void, voidable, or unenforceable, and no such party shall be entitled to rescind, or

> recover any payment made with respect to, such an agreement, contract, transaction, or instrument under this section or any other provision of Federal or State law, based solely on the failure of the agreement, contract, transaction, or instrument to comply with the terms or conditions of an exemption or exclusion from any provision of this Act or regulations of the Commission." (emphasis added)

The Futures Trading Practices Act of 1992 added provisions to Section 12(e) of the CEA that preempted the application of state gaming and bucket shop laws to OTC derivatives transactions covered by an exemption granted by the CFTC pursuant to Section 4(c) of the CEA. The effect of this provision was to preempt the application of such state laws to transactions covered by the 1993 Swaps Exemption. The Act replaces Section 12(e)(2) of the CEA with a new provision that preempts the application of state gaming and bucket shop laws to transactions excluded from the CEA or exempt under regulations of the CFTC, whether or not the transactions would otherwise be subject to the CEA. This new provision makes preemption applicable to transactions covered by all the new exclusions in the Act as well as by the revised Treasury Amendment (see part IX below) and the new exclusion for electronic trading facilities (see part VII below).

V. Legal Certainty for Excluded Derivative Transactions and for Excluded Swap Transactions

1. Section 2(d)(1).

New Section 2(d)(1) of the CEA states that nothing in the CEA (other than new Section 5b, which governs the regulation of derivatives clearing organizations, and revised Section 12(e)(2)(B), which is the preemption provision discussed in part IV above) governs or applies to a transaction in an "excluded commodity" if the transaction is (A) between persons that are eligible contract participants at the time they enter into the transaction and (B) not entered into or traded on a trading facility.

The Swaps Exemption (Part 35 of the CFTC Regulations) contains four elements:

(1) the swap agreement is entered into between eligible swap participants;

(2) the swap agreement is not part of a fungible class of agreements that are standardized as to their material economic terms;

(3) the creditworthiness of the parties is a material consideration in entering into or determining the terms of the swap agreement; and

(4) the swap agreement is not entered into or traded through a multilateral transaction execution facility.

The exclusion in new Section 2(d)(1) is much broader than the exemption embodied in the Swaps Exemption. First, a statutory exclusion that can only be modified by Congress is inherently more robust than a regulatory exemption that can be modified by agency action. Second, Section 2(d)(1) applies to any transaction and not just to swap agreements. Third, "eligible contract participant" is broader than "eligible swap participant" in several respects. Fourth, both the nonfungibility and creditworthiness requirements in the Swaps Exemption have been dropped. Finally, Section 2(d)(1) replaces "multilateral transaction execution facility" with "trading facility". The significance of this last change will only become apparent over time as the term "trading facility" is clarified through interpretation and experience. There is, of course, a separate exclusion for transactions executed through an electronic trading facility, as explained immediately below.

2. <u>Section 2(d)(2).</u>

New Section 2(d)(2) of the CEA provides an exclusion for transactions involving excluded commodities

that are executed or traded on an electronic trading facility. This exclusion covers all provisions of the CEA except Section 5a (to the extent provided in Section 5a(g), which permits a board of trade that elects to become a registered derivatives transaction execution facility to trade on the facility any transaction involving excluded or exempt commodities other than securities), Section 5b (governing the regulation of derivatives clearing organizations), 5d (governing exempt boards of trade) and Section 12(e)(2)(B) (the preemption provision discussed in part IV above). Section 2(d)(2) states that nothing in the CEA (except as noted immediately above) governs or applies to a transaction in an "excluded commodity" if the transaction is:

> **(A) entered into on a principal-to-principal basis by parties trading for their own account or by a party trading as an authorized investment manager or fiduciary as described in part III.2.C above;**
>
> **(B) between persons that are eligible contract participants (other than when acting as a broker or in a similar agency function) at the time they enter into the transaction; and**

(C) executed or traded on an electronic trading facility.

Speaking in the Senate on December 15, 2000, Senator Gramm, Chairman of the Senate Banking Committee, explained one aspect of the principal-to-principal requirement as follows:

> "The Commodity Futures Modernization Act of 2000 excludes from its coverage agreements, contracts or transactions in an excluded commodity entered into on an electronic trading facility provided that such agreements, contracts or transactions are entered into only by eligible contract participants on a principal-to-principal basis trading for their own accounts. In some cases, a party may enter into an agreement, contract or transaction on an electronic trading facility that mirrors another agreement, contract or transaction entered into at about the same time with a customer. The risk of one transaction may be largely or completely offset by the other; and that may be the purpose for entering into both transactions. But the party entering into both transactions remains liable to each of its counterparties throughout the life of the transaction. That party is similarly exposed to the credit risk of each of its counterparties. The fact that a party has entered into back-to-back transactions as described above does not alter the principal-to-principal nature of each of the transactions and must not be construed to affect the eligibility of either transaction for the electronic trading facility exclusion." 146 Cong. Rec. S11867-8 (2000).

In a similar vein, in a Floor Statement released on December 15, 2000, Congressman Leach stated that:

> "A 'principal-to-principal' transaction includes any transaction whereby a party to the transaction books the transaction for the party's own account. It includes 'riskless principal' transactions, whereby one

> party enters into a transaction and thereafter or contemporaneously enters into an offsetting transaction so that the risk or payments under the transactions net out. The fact that the party has entered into offsetting transactions in no way alters the 'principal-to-principal' nature of the transaction, and any party that has entered into a 'riskless principal' transaction may be assured that its contracts remain legally enforceable and excluded or exempted from the jurisdiction of the CFTC and/or SEC, as applicable." Floor Statement of Congressman James A. Leach on the Commodity Futures Modernization Act (Dec. 15, 2000).

3. Section 2(g).

Although entitled "Excluded Swap Transactions", new Section 2(g) of the CEA applies to any transaction in a commodity other than an agricultural commodity. The Section 2(g) exclusion covers all provisions of the CEA subject to the same exceptions as set forth in Section 2(d)(2), which are explained in part V.2 immediately above. Section 2(g) states that nothing in the CEA (except as noted) governs or applies to a transaction in any commodity (other than an agricultural commodity) if the transaction is:

(A) between persons that are eligible contract participants at the time they enter into the transaction;

(B) subject to individual negotiation by the parties; and

(C) not executed or traded on a trading facility.

There is a great deal of overlap between the exclusions in Section 2(d)(1) (see part V.1 above) and Section 2(g). Section 2(d)(1), however, applies to "excluded commodities", while Section 2(g) applies to all commodities except agricultural commodities. The Section 2(g) exclusion thus will be particularly relevant to transactions not executed on a trading facility that involve metals, chemicals or energy products. In addition, the "subject to individual negotiation" requirement in Section 2(g) does not appear in Section 2(d)(1).

4. Title IV--Covered Swap Agreements.

As discussed in part X.2 below, Title IV of the Act (the Legal Certainty for Bank Products Act of 2000) creates an exclusion from the CEA for "covered swap agreements". The terms of this exclusion are substantially similar in aggregate effect to the exclusions discussed above. On a procedural level, the exclusions discussed above will in the first instance be interpreted by the CFTC. The exclusion for "covered swap agreements" in Title IV of the Act should in the first instance be interpreted by the banking regulators.

VI. Legal Certainty for Transactions in Exempt Commodities

1. Section 2(h)(1).

New Section 2(h)(1) of the CEA states that nothing in the CEA (other than as noted immediately below) applies to a transaction in an "exempt commodity" if the transaction is (A) between persons that are eligible contract participants at the time they enter into the transaction and (B) not entered into on a trading facility. The provisions of (A) and (B) immediately above are almost identical to the comparable provisions of Section 2(d)(1). See part V.1 above. The only exceptions to the exclusion in Section 2(d)(1), however, are Sections 5b and 12(e)(2)(B) of the CEA. The exceptions to the exclusion in Section 2(h)(1) include not only Sections 5b and 12(e)(2)(B) but also a variety of provisions proscribing fraud in connection with commodity option transactions that are not between eligible commercial entities and manipulation of the market price of any commodity. "Eligible commercial entities" is defined as certain types of eligible contract participants that (i) have the ability to make or take delivery of the underlying commodity, (ii) incur commodity risks in addition to price risk or (iii) are dealers in either the underlying commodity or derivatives transactions involving that commodity.

2. <u>Section 2(h)(3).</u>

New Section 2(h)(3) of the CEA provides an exclusion for transactions involving "exempt commodities" that are executed or traded on an electronic trading facility. Section 2(h)(3) states that nothing in the CEA (other than as noted immediately below) applies to a transaction in an "exempt commodity" if the transaction is (A) entered into on a principal-to-principal basis between persons that are eligible commercial entities at the time they enter into the transaction and (B) executed or traded on an electronic trading facility. There are various exceptions to this exclusion. The exceptions include Sections 5a (to the extent provided in Section 5a(g)), 5b, 5d and 12(e)(2)(B); these are the same exceptions as stipulated for the exclusion in Section 2(d)(2). See part V.2 above. In addition, the exceptions to Section 2(h)(3) include Sections 4b and 4o of the CEA and the related regulations proscribing fraud in connection with commodity option transactions and Sections 6(c) and 9(a)(2) of the CEA prohibiting manipulation of the market price of any commodity. Finally, the exceptions to the exclusion in

Section 2(h)(3) include any rules and regulations adopted by the CFTC to ensure timely dissemination by the electronic trading facility of trading data if the CFTC determines that the facility performs a significant price discovery function for the underlying commodity.

Section 2(h)(5) sets forth a variety of notification, certification, access to trading protocols and reporting obligations for any electronic trading facility relying on the exclusion set forth in Section 2(h)(3).

VII. Legal Certainty for Excluded Electronic Trading Facilities

New Section 2(e)(1) of the CEA states that nothing in the CEA (except the preemption provision in Section 12(e)(2)(B)) governs or is applicable to an electronic trading facility that limits transactions authorized to be conducted on its facilities to those satisfying the requirements of Section 2(d)(2) (excluded commodities; see part V.2 above), Section 2(g) (excluded swap transactions; see part V.3 above) or Section 2(h)(3) (exempt commodities; see part VI.2 above). A designated contract market or a derivatives transaction execution facility is free to establish an excluded electronic trading facility.

VIII. Exclusion for Qualifying Hybrid Instruments

New Section 2(f)(1) of the CEA states that nothing in the CEA (except the preemption provision in Section 12(e)(2)(B)) governs or is applicable to a hybrid instrument that is predominantly a security. A hybrid instrument is predominantly a security if:

(A) the issuer receives payment in full of the purchase price substantially contemporaneously with delivery of the instrument;

(B) the holder of the instrument is not required to make any payments to the issuer, whether as margin, settlement payments, or otherwise, other than the purchase price, during the life of the instrument or at maturity;

(C) the issuer is not subject by the terms of the instrument to mark-to-market margining requirements;[5] and

[5] The Act makes clear that the mark-to-market limitation would not prevent an issuer of a secured debt obligation from increasing the amount of collateral pledged for the benefit of the holder to secure the issuer's repayment obligations.

(D) the instrument is not marketed as a futures contract or option on a futures contract.

This new hybrid instrument exclusion is substantially broader than the existing Hybrid Instrument Exemption (Part 34 of the CFTC Regulations) in several respects. First, hybrid instruments no longer have to satisfy the predominance test of whether the aggregate value of the commodity-independent components of the instrument exceeds the aggregate value of its commodity-dependent components. Second, hybrid instruments no longer are subject to a restriction on settlement by delivery of an instrument specified in the rules of a designated contract market. Finally, the exclusion is not subject to the limitations formerly imposed by Section 2(a)(1)(B) of the CEA (the Shad-Johnson Accord).

Hybrid instruments that are predominantly identified banking products are dealt with elsewhere in the Act. See part X.1 below.

IX. Legal Certainty for Treasury Amendment Products

The Act modifies the existing Treasury Amendment by providing a new Section 2(c) of the CEA. Under the new Section 2(c), the CEA, with limited exceptions, does not govern or apply to a transaction in foreign currency, government securities, security warrants, security rights, resales of installment loan contracts, repurchase transactions in an excluded commodity, or mortgages or mortgage purchase commitments. Exceptions to this exclusion include Sections 5a (to the extent provided in Section 5(a)(g)), 5b, 5d and 12(e)(2)(B) of the CEA; these are the same exceptions as stipulated for the exclusion in Section 2(d)(2). See part V.2 above.

The Act also includes two other important limits on the Section 2(c) exclusion. The first grants the CFTC jurisdiction over futures contracts (or options thereon) or commodity options involving any of these enumerated products executed or traded on an "organized exchange". Organized exchange is defined as a "trading facility" that (A)(i) permits trading by or on behalf of a person that is not an eligible contract participant or (ii) permits trading other than on a principal-to-principal basis or (B) has adopted rules that (i) govern the conduct of participants (other than with respect to the submission of orders or execution of transactions on the facility), and (ii) contain disciplinary sanctions (other than exclusion from trading on the system). Organized exchange does not include a national securities exchange.

In addition, the CFTC is granted jurisdiction over foreign currency futures contracts (or options thereon) and options on foreign currencies offered to be entered into with a person that is not an eligible contract participant, unless entered into on a national securities exchange or unless the counterparty is one of an enumerated group of directly or indirectly regulated entities, such as a bank or other financial institution, broker-dealer, insurance company, financial holding company or investment bank holding company.

The changes in the Treasury Amendment eliminate the uncertainty in the former Treasury Amendment concerning the definition of "board of trade" by providing that transactions in the enumerated products are exempt unless effected on an organized exchange. Organized exchange is defined in such a way as to exclude CEA regulation of transactions executed through trading facilities on which participation is limited to eligible contract participants dealing on a principal-to-principal basis.

X. Regulatory Responsibility for Bank Products

The Act includes a new Title IV, which is entitled the "Legal Certainty for Bank Products Act of 2000". This title is part of neither the banking laws nor the CEA.

Title IV excludes the application of any provision of the CEA to, and CFTC regulatory authority over, certain identified banking products, hybrid instruments that are predominantly banking products and covered swap agreements.

1. <u>Identified Banking Products and Hybrid Instruments.</u>

Section 403 of Title IV provides an unqualified exclusion for an identified banking product if:

> **(A) an appropriate banking agency certifies that the identified banking product has been commonly offered, entered into or provided in the United States by any bank on or before December 5, 2000, under applicable banking law; and**
>
> **(B) the product was not prohibited by the CEA and not regulated by CFTC as a contract of sale of a commodity for future delivery (or an option on such a contract) or an option on a commodity, on or before December 5, 2000.**

Section 404 of Title IV provides an exclusion from all provisions of the CEA for new banking products offered after December 5, 2000 if:

(A) the product is not linked to and does not provide for delivery of any commodity (as broadly defined in Section 1(a)(4) of the CEA); or

(B) the product or commodity is otherwise excluded from the CEA.

Section 405 of Title IV provides another exclusion from all provisions of the CEA for a product that is a hybrid instrument that is predominantly a banking product under a predominance test that is the same as the test hybrid instruments in new Section 2(f)(1) of the CEA. See part VIII above. Section 406 of Title IV sets forth procedures for decisions on predominance issues that involve both the CFTC and the Board of Governors of the Federal Reserve System.

Title IV defines "identified banking product" by reference to paragraphs (1) through (5) of Section 206(a) of the Gramm-Leach-Bliley Act, which define the term to include:

(1) a deposit account, savings account, certificate of deposit, or other deposit instrument issued by a bank;

(2) a banker's acceptance;

(3) a letter of credit issued or loan made by a bank;

(4) a debit account at a bank arising from a credit card or similar arrangement;

(5) a participation in a loan which the bank or an affiliate of the bank (other than a broker or dealer) funds, participates in, or owns that is sold--

(A) to qualified investors; or

(B) to certain other persons.

Title IV modifies the Gramm-Leach-Bliley definition of "bank" to cover any Federal depository institution, any non-U.S. bank or any U.S. branch or agency of a non-U.S. bank, any credit union, any trust company, certain corporations operating under the Federal Reserve Act and any of their respective subsidiaries that are regulated as part of the parent entity. Broker-dealers and futures commission merchants are specifically excluded. In addition, the Gramm-Leach-Bliley term "qualified investor" is replaced by "eligible contract participant" as defined in the Act.

2. <u>Covered Swap Agreements.</u>

Title IV also states a definition of "covered swap agreement". This definition in Title IV starts with Section 206(b) of Gramm-Leach-Bliley, which provides as follows:

> "[T]he term 'swap agreement' means any individually negotiated contact, agreement, warrant, note, or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices, or other assets, but does not include any other identified banking product, as defined in paragraphs (1) through (5) of subsection (a)."

Section 402(d) of the Act then provides that "covered swap agreement" means a swap agreement (as defined in section 206(b) of the Gramm-Leach-Bliley Act), including a credit or equity swap, based on a commodity other than an agricultural commodity enumerated in Section 1a(4) of the CEA if:

(1) the swap agreement:

(A) is entered into only between persons that are eligible contract participants; and

(B) is not entered into or executed on a trading facility; <u>or</u>

(2) the swap agreement:

(A) is entered into or executed on an electronic trading facility;

(B) is entered into on a principal-to-principal basis between parties trading for their own accounts or by a party trading as an authorized investment manager or fiduciary as described in part III.2.C above;

(C) is entered into by persons that are eligible contract participants (other than when acting as a broker or in a similar agency function) at the time they enter into the transaction; and

(D) is a transaction in an excluded commodity.

Section 407 then sets forth a broad exclusion for "covered swap agreements". It provides that no provision of the CEA (other than Section 5b with respect to the clearing of covered swap agreements) shall apply to, and the CFTC shall not exercise regulatory authority with respect to, a covered swap agreement offered, entered into or provided by a bank.

XI. Regulatory Responsibility for Security-Based Swap Agreements

Title III of the Act amends both the 1933 Act and the 1934 Act to clarify the status of "swap agreements"

under the U.S. securities laws. The Act adds a new definition of "swap agreement" in the form of Section 206A of the Gramm-Leach-Bliley Act. This new definition includes a broad array of interest rate, currency, credit, equity, commodity, weather and other derivatives, provided that transactions are entered into by eligible contract participants and the material terms of the transaction (other than price and quantity) are subject to individual negotiation. "Swap agreement" for this purpose does not include transactions involving the purchase or sale of a security or a put, call, straddle or option on a security, using for this purpose the definition of "security" found in Section 2(a)(1) of the 1933 Act and Section 3(a)(10) of the 1934 Act. Title III adds a new Section 2A to the 1933 Act and a new Section 3A to the 1934 Act stating that for purposes of the U.S. securities laws "security" does not include any "swap agreement". These new provisions effectively end any confusion about the status of swaps under the U.S. securities laws that arose from the enforcement order of the SEC involving Bankers Trust Company dated December 22, 1994.

Title III of the Act distinguishes between "security-based swap agreements" and "non-security based swap agreements". The former means a "swap agreement" (as defined above in this part XI) of which a material term is based on the price, yield, value or volatility of any security or any group or index of securities. The latter means any swap agreement that is not a security-based swap agreement.

Security-based swap agreements are subject to specific antifraud, antimanipulation and anti-insider trading provisions of the 1933 Act and 1934 Act (including judicial precedents under those provisions) to the same extent such provisions are applicable to securities. The SEC may not, however, promulgate or enforce rules or orders that impose reporting or recordkeeping requirements or other procedures or standards as prophylactic measures against fraud, manipulation or insider trading with respect to security-based swap agreements, or otherwise regulate or require the registration of security-based swap agreements under either the 1933 Act or the 1934 Act.

Speaking in the Senate on December 15, 2000, Senator Gramm provided the following explanation of the SEC's authority concerning security-based swap agreements:

> "Under Title III of the bill, the SEC is granted new authority to undertake certain enforcement actions in connection with security-based swap agreements. It is

important to emphasize that nothing in the title should be read to imply that swap agreements are either securities or futures contracts. To emphasize that point, the definition of a 'swap agreement' is placed in a neutral statute, the Gramm-Leach-Bliley Act, that is, legislation that is not specifically part of a banking, securities, or commodities law. However, drawing upon the SEC's enforcement experience, the SEC is permitted, on a case-by-case basis, with respect to security-based swap agreements (as defined in the legislation) to take action against fraud, manipulation, and insider trading abuses. Title III makes it clear that the SEC is not to impose regulations on such instruments as prophylactic measures. Banks are already heavily regulated institutions. Further regulatory burden, rather than discouraging wrongdoing, would be more likely to discourage development and innovation, driving business overseas instead. The SEC is directed to focus on the wrong doers rather than provide new paperwork burden and regulatory costs on the law abiding investors and financial services providers. For example, the SEC is directed not to require the registration of security-based swap agreements. If a registration statement is submitted to the SEC and accepted by the SEC, the agency is required promptly to notify the registrant of the error, and the registration statement will be null and void." 146 Cong. Rec. S11867 (2000).

XII. Other Important Provisions of the Act

1. Clearing.

While transactions qualifying for the exclusions described above may be cleared, Congress wanted to be sure that clearing organizations themselves are subject to suitable regulation. The Act establishes two new categories of regulated clearing organizations for derivatives: "multilateral clearing organizations", which are subject to banking regulation; and "derivatives clearing organizations", which are subject to CFTC regulation. OTC derivatives transactions eligible for the exclusions described above in this Memorandum, if cleared, must be cleared through a multilateral clearing organization, a derivatives clearing organization registered under the CEA, a securities clearing agency regulated by the SEC under the 1934 Act or certain foreign clearing organizations approved by the SEC, the CFTC or the Federal banking regulators. Clearing will not, however, make those exclusions unavailable.

CFTC-registered derivatives clearing organizations must comply with a set of core principles and will be regulated independently of any trading facility for which they clear transactions.

2. Regulatory Relief for Contract Markets.

The Act creates three tiers of regulation for boards of trade based on whether the underlying commodities being traded are susceptible to manipulation and whether the users of the facility are limited to eligible contract participants.

The highest level of regulation is for designated contract markets. The Act amends the current approach to regulation of these markets with a series of "core principles" that are intended to be more flexible. Existing contract markets are not required to requalify under the new provisions, although they will be subject to ongoing compliance with the core principles.

The Act creates a new category of regulated trading facility, known as a Derivatives Transaction Execution Facility or "DTEF", which is subject to less regulation (through a less comprehensive body of core principles) than a designated contract market. Operation as a DTEF will require registration under new Section 5a(c) of the CEA. The Act permits a narrower range of contracts to be traded on DTEFs than on contract markets, depending in part on the types of participants granted access. Transactions involving any commodity (other than an agricultural commodity) are permitted if the DTEF limits access to "eligible commercial entities"[6] trading for their own accounts. If trading access is not so limited, the DTEF may permit transactions involving any underlying commodity

[6] "Eligible commercial entities" is defined as certain types of eligible contract participants that (i) have the ability to make or take delivery of the underlying commodity, (ii) incur commodity risks in addition to price risk or (iii) are dealers in either the underlying commodity

that has (i) a nearly inexhaustible deliverable supply, (ii) a deliverable supply that is sufficiently large that the contract is "highly unlikely to be susceptible to the threat of manipulation" or (iii) no cash market. Trading access must be limited to eligible contract participants or persons trading through a futures commission merchant that has net capital of at least $20,000,000 and meets certain other requirements. The Act also permits trading on a DTEF of transactions that would otherwise be excluded or exempt from the CEA under the provisions described in other parts of this Memorandum.

The Act further authorizes a third category of trading facility, an "exempt board of trade". Becoming an exempt board of trade does not require registration with the CFTC; it merely requires receipt by the CFTC from the exempt board of trade of a notice in a manner to be prescribed by the CFTC. To qualify, an exempt board of trade may permit only contracts for sale of a commodity for future delivery (or options on such contracts or on a commodity) between eligible contract participants for which the underlying commodity has (i) a nearly inexhaustible deliverable

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or derivatives transactions involving that commodity.

supply, (ii) a deliverable supply that is sufficiently large, and a cash market sufficiently liquid, "to render any contract traded on the commodity highly unlikely to be susceptible to the threat of manipulation", or (iii) no cash market. Contracts involving securities or any group or index of securities may not be traded on an exempt board of trade. A party to a transaction that is traded on an exempt board of trade is subject to various antimanipulation and antifraud provisions of the CEA. In addition, if the CFTC finds that an exempt board of trade is a significant source of price discovery for the cash market for the commodity underlying any transaction traded through the exempt board of trade, the board of trade will be required to disseminate publicly on a daily basis trading volume, price and other trading data as appropriate to the market. Although transactions involving "excluded commodities" may be traded through an exempt board of trade, doing so would appear to submit such transactions to antifraud and antimanipulation provisions of the CEA that would not apply under Section 2(d)(2) of the CEA if the same transactions were entered into through an electronic trading facility. See part V.2 above.

A designated contract market or a DTEF is permitted to operate an exempt board of trade so long as it is organized as a separate legal entity.

3. Futures on Single and Narrow Indices of Securities.

Until the Act became law, Section 2(a)(1)(B) of the CEA (the Shad-Johnson Accord) prohibited futures on single shares and narrow indices of securities. The Act will now permit the trading in the United States of futures on individual securities and narrow-based groups or indices of securities. Thus provisions generally will not take effect for one year. Regulation is to be coordinated by both the CFTC and the SEC. Related tax provisions were adopted as part of the Community Renewal Tax Relief Act of 2000; these provisions generally conform the taxation of futures on single shares or narrow indices of securities to the taxation of options on single shares.

Section 201 of the Act amends Section 3(a) of the 1934 Act to add a definition of "security future", which is "a contract for sale for future delivery of a single security or of a narrow-based security index, including any interest therein or based on the value thereof" subject to certain exceptions. In particular, "security future" does not include any transaction excluded from the CEA under CEA Sections 2(c) (Treasury Amendment; see part IX above), 2(d) (excluded derivatives transactions; see part V above), 2(f) (hybrid instruments; see part VIII above) or 2(g) (swap transactions); see part V.3 above) or under Title IV of the Act (identified banking products and covered swap agreements; see part X above). These exclusions from the definition of "security future" were intended to clarify that OTC derivatives transactions among eligible contract participants related to the prices of securities are outside the jurisdiction of the SEC.

XIII. Future Developments--Retail Study

Section 105(c) of the Act directs the Board of Governors of the Federal Reserve System, the Secretary of the Treasury, the CFTC and the SEC to conduct a study of issues involving offering swap agreements to persons other than eligible contract participants. The study will address:

(A) the potential uses of swap agreements by persons other than eligible contract participants;

(B) the extent to which financial institutions are willing to offer swap agreements to persons other than eligible contract participants;

(C) the appropriate regulatory structure to address customer protection issues that may arise in connection with the offer of swap agreements to persons other than eligible contract participants; and

(D) other relevant matters deemed necessary or appropriate.

A report is due to be submitted to Congress within one year after enactment of the Act. The report will include recommendations for necessary and appropriate legislative action.

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