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Legal and Regulatory Issues Remain

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Ranking Minority Member
Committee on Agriculture, Nutrition
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United States Senate

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Committee on Agriculture
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In the past quarter century, technological advances and fundamental changes in the global financial markets have accelerated the development and use of financial products generically called derivatives.[1] Derivatives include futures contracts[2] that traditionally have been traded on organized exchanges and are regulated by the Commodity Futures Trading Commission (CFTC) under the Commodity Exchange Act (CEA).[3] They also include swaps[4] and other over-the-counter (OTC) derivatives contracts that resemble exchange-traded futures in their economic function but are privately negotiated between counterparties outside organized exchanges. As we and others have reported,[5] derivatives can serve a useful risk-management function, but their use can pose risks to participants and the markets. The total notional/contract amount of derivatives contracts

[1]Derivatives are contracts that have a market value determined by the value of an underlying asset, reference rate, or index (called the underlying). Underlyings include stocks, bonds, agricultural and other physical commodities, interest rates, foreign-currency rates, and stock indexes.

[2]Futures contracts are derivatives that obligate the holder to buy or sell a specific amount or value of an underlying asset, reference rate, or index at a specified price on a specified future date.

[3]7 U.S.C. 1 et seq.

[4]Swaps are privately negotiated contracts that typically require counterparties to make periodic payments to each other for a specified period. The calculation of these payments is based on an agreed-upon amount, called the notional amount, that is not typically exchanged.

[5]See Financial Derivatives: Actions Needed to Protect the Financial System (GAO/GGD-94-133, May 18, 1994) and the update to this report, Financial Derivatives: Actions Taken or Proposed Since May 1994 (GAO/GGD/AIMD-97-8, Nov. 1, 1996).

outstanding worldwide was an estimated $55.7 trillion as of March 31, 1995.[6]

Because of their resemblance to exchange-traded futures, swaps and other OTC derivatives faced the possibility of falling within the judicially crafted definition of a futures contract. As a result, they faced the legal risk of being unenforceable under the CEA due to its requirement that futures be traded on exchanges to be legal and thus enforceable. The Futures Trading Practices Act of 1992 (P.L. 102-546) provided CFTC with authority to reduce this legal risk, which the agency subsequently used. At the same time, developments in the exchange-traded futures and OTC derivatives markets brought regulated financial institutions into these markets, leading to a greater array of derivatives contracts and greater competition among those providing such contracts. Consequently, some of the distinctions among market participants and between exchange-traded futures and OTC derivatives have become blurred—raising questions about the appropriate regulatory structure for these contracts, markets, and market participants. Because of the Committees' interest in the CEA and congressional interest in the continued vitality and integrity of the U.S. exchange-traded futures and OTC derivatives markets, we initiated this review to provide Congress a context for addressing these questions. Specifically, we focused on (1) the extent to which CFTC has reduced the legal risk surrounding the enforceability of OTC derivatives under the CEA and (2) issues related to the appropriate regulation for exchange-traded futures and OTC derivatives contracts, including their markets and market participants.

Results in Brief

Under the authority provided by the Futures Trading Practices Act of 1992, CFTC exempted most swaps and other OTC derivatives contracts from the CEA's exchange-trading requirement and, in doing so, reduced or eliminated the legal risk that they could be unenforceable. The legal risk arose from the possibility that CFTC or a court could find that swaps and other OTC derivatives fell within the judicially crafted definition of a futures contract, in part because, like futures, they served a risk-shifting function. If determined to be futures, these contracts would have violated the CEA's requirement that futures be traded on an organized exchange, making them illegal and thus unenforceable. In granting the exemptions, CFTC was not required to, and did not, determine that OTC derivatives were futures. As a result, a question has remained about whether OTC derivatives

[6]This estimate was based on a comprehensive survey done by the Bank for International Settlements and represents the most current data available. The notional amount of derivatives contracts is one way that derivatives activity is measured. Because the notional amount is not exchanged in most OTC derivatives transactions, it is not typically a measure of the amount at risk.

are futures and can be regulated under the act. The possibility that swaps are futures continues to be a source of legal risk for a narrow group of swaps—so-called equity swaps—that are ineligible for exemption from the act's requirements. Legal risk also remains for certain agricultural forwards[7] that are becoming increasingly difficult to distinguish from futures and that may not be eligible for the swaps exemption.

Although CFTC reduced or eliminated the legal risk of being unenforceable for most swaps and other OTC derivatives, a broader policy question remains about the appropriate regulation for OTC derivatives and exchange-traded futures, including their markets and market participants. We discuss three issues that are related to this policy question. The first issue concerns the appropriate regulation for the OTC foreign-currency market under the CEA. The act excludes from its regulation certain OTC foreign-currency transactions, but the scope of the exclusion—called the Treasury Amendment—has been the subject of disagreement among federal regulators and the courts. A recent U.S. Supreme Court decision resolved that the exclusion covers all transactions in foreign currency, including foreign-currency options and futures.[8] The Court did not, however, address the meaning of language that saves from the exclusion sales for future delivery conducted on a board of trade. As a result, the extent to which the Treasury Amendment excludes transactions involving unsophisticated market participants may still be subject to debate.

The second issue concerns the potential for the swaps market to evolve beyond its exemption and raise additional regulatory concerns. CFTC exempted swaps from virtually all CEA requirements but imposed conditions on the exemption that restricted their design and trading procedures. Although difficult to predict, the swaps market might develop in ways that are inconsistent with these conditions. Should this occur, CFTC could use its exemptive authority to accommodate market developments and address any regulatory concerns, but such an approach could introduce, among other things, jurisdictional questions involving

[7]Forwards are privately negotiated contracts in which the buyer and seller agree upon delivery of a specified quality and quantity of goods at a specified future date. A price may be agreed upon in advance or determined at the time of delivery. Delivery is typically expected, although it may not occur.

[8]CFTC v. Dunn, 65 U.S.L.W. 4141 (U.S. Feb. 25, 1997), rev'g 58 F. 3d 50 (2d Cir. 1995).

other federal regulators. The President's Working Group on Financial Markets provides one forum for addressing such questions.[9]

The third issue concerns the rationale for the regulatory differences between the OTC derivatives and exchange-traded futures markets. The types of contracts transacted in each market serve similar economic functions but differ in other ways, including the way they are traded and regulated. CFTC recently granted the exchanges an exemption to enable them to better compete against the less regulated OTC derivatives market. However, under the exemption, regulation of the two markets will continue to differ substantially. While the exchange exemption represents one approach to rationalizing the regulatory differences between the markets, it also illustrates some of the challenges in doing so.

In attempting to address the appropriate regulation of the exchange-traded futures and OTC derivatives markets, three fundamental questions arise concerning the goals of federal policy. These questions are (1) what is the current public interest in these markets that needs to be protected; (2) what type of regulations are needed, if any; and (3) what is the most efficient and effective way to implement and enforce any needed regulations? Ultimately, maintaining globally competitive U.S. derivatives markets will require balancing the goal of allowing the U.S. financial services industry to innovate and grow with the goal of protecting customers and the market, including its efficiency, fairness, and financial integrity.

Background

The Futures Market Is Regulated Under the CEA

Futures contracts first appeared in the United States in the mid-1800s and were based on grains. They provided producers (farmers) and commodity users with a means of reducing the risk of financial loss arising from adverse fluctuations in commodity prices, called hedging. They also provided a more efficient and transparent means of determining commodity prices based on supply and demand factors, called price discovery. Because of concerns about price manipulation and other trading abuses in the futures market, including the operation of bucket

[9]The President's Working Group on Financial Markets was created following the October 1987 stock market crash to address issues concerning the competitiveness, integrity, and efficiency of the financial markets. The Secretary of the Treasury chairs the working group, and other members include the chairs of CFTC, the Federal Reserve System, and the Securities and Exchange Commission.

shops,[10] Congress passed the CEA in 1936 to amend the Grain Futures Act of 1922. Like its predecessor, the CEA required that futures trading in specified commodities—such as corn, rye, and wheat—be conducted only on federally designated markets. To receive such a designation, an exchange had to meet certain self-regulatory requirements that included providing for the prevention of manipulation and fraud. Congress periodically amended the act to bring futures trading in additional commodities under the CEA. For example, Congress amended the act in 1968 and brought futures trading in livestock, livestock products, and frozen concentrated orange juice under federal regulation.

By the early 1970s, futures trading had expanded to include nonagricultural commodities, such as precious metals and foreign currencies. Although contracts on these commodities were traded on futures exchanges, they were not covered by the act and, thus, were not federally regulated. In 1974, Congress amended the CEA to ensure that all futures contracts—whatever their underlying commodity—would be federally regulated. It accomplished this goal by expanding the list of commodities covered by the act to include virtually anything, tangible or intangible.[11] As a result, the class of instruments that could be defined as futures and subject to the act's exchange-trading requirement was broadened. Any contract that was legally categorized as a futures contract could be traded only on federally designated exchanges, making the off-exchange trading of futures illegal.

The 1974 amendments to the CEA also created CFTC to administer the CEA.[12] The CEA gives CFTC exclusive jurisdiction over futures and establishes a comprehensive regulatory structure designed to protect the futures market and its participants. Historically, CFTC's regulatory structure was designed to assure that all futures contracts were traded on self-regulated exchanges and through regulated intermediaries, which were subject to capital, examination, recordkeeping, registration, reporting, and customer protection requirements. The CEA's exchange-trading requirement was intended to foster both market integrity and customer protection by creating a centralized market that could be protected against excessive

[10]Bucket shops are firms that purport to conduct a legitimate business by accepting orders for futures contracts, but that do not actually execute the orders in the futures market. When the price on the futures market moves against the bucket shops, they often close their doors or file for bankruptcy protection, leaving uncollectible debts.

[11]The list of specified commodities was expanded to include "all goods and articles . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."

[12]Before the 1974 amendments to the CEA, the Department of Agriculture administered the act and regulated the futures market.

speculation, price manipulation,[13] and other abusive trade practices. According to the act, regulation of the futures market was necessary to protect the public interest, because futures prices were susceptible to excessive speculation and could be manipulated to the detriment of producers, consumers, and others. Moreover, the act's legislative history noted that the fundamental purposes of the act were to ensure fair practices and honest dealing in the futures market and to control those forms of speculative activity that demoralize the market to the detriment of producers, consumers, and the markets.

While providing for their regulatory oversight, the CEA does not define the term futures contract. Instead, CFTC and the courts have identified certain elements as necessary, but not always sufficient, for defining a futures contract. These elements are

- the obligation of each party to fulfill the contract at a specified price set at the contract's initiation,
- the use of the contract to shift or assume the risk of price changes, and
- the ability to satisfy the contract by either delivering the underlying commodity or offsetting[14] the original contract with another contract.

CFTC and the courts have also identified additional elements of exchange-traded futures contracts, including standardized terms, margin requirements,[15] use of clearinghouses,[16] open and competitive trading in centralized markets (such as futures exchanges), and public price dissemination. These additional elements facilitate futures trading on exchanges but do not define what makes a contract a futures contract. Also, according to CFTC and the courts, the requirement that a futures contract be exchange-traded is what makes the contract legal, not what makes it a futures contract. Because CFTC and the courts have defined a futures contract in a way that reflects its risk-shifting function, the CEA

[13]Manipulation is the distortion of market prices for economic gain. The distortion typically involves creating artificial prices that do not reflect supply and demand conditions, or creating a false picture of supply and demand conditions to cause a desired price movement and/or reaction by other market participants.

[14]Offset for exchange-traded futures is the liquidation of a long (short) futures position through the sale (purchase) of an equal number of contracts of the same delivery month.

[15]Margins are the cash or collateral deposited by customers with their agents for the purpose of insuring the agents and, ultimately, clearinghouses against loss on open exchange-traded futures contracts.

[16]Clearinghouses are responsible for the daily clearance and settlement of all trades. Clearance is the process of capturing the trade data, comparing buyer and seller versions of the data, and guaranteeing that the trade will settle once the data are matched. Settlement is the process of fulfilling contractual requirements through cash payment or delivery.

potentially covers a broad range of risk-shifting products that are not exchange-traded.

The CEA also provides CFTC with jurisdiction over commodity options,[17] except options on securities[18] and options on foreign currencies traded on a national securities exchange. CFTC's options jurisdiction is further limited by the recent U.S. Supreme Court decision in CFTC v. Dunn.[19] Commodity options include options to acquire futures contracts (called options on futures) and options to acquire the actual commodity, excluding securities. CFTC has issued regulations to allow futures exchanges, subject to its approval, to trade options on futures in any commodity and options on actual commodities other than domestic agricultural commodities. Futures exchanges have been trading options since 1982, and virtually all options traded on futures exchanges are options on futures. CFTC has also issued regulations to allow certain options on commodities other than domestic agricultural commodities (called trade options) to be traded off-exchange. These OTC options are to be offered and sold to commercial counterparties who enter into transactions for purposes related solely to their business.

Since the 1974 amendments to the CEA and the creation of CFTC, the U.S. futures market has evolved far beyond its agricultural origins and is now dominated by futures based on financial products. In 1975, the largest commodity group was domestic agricultural commodities, accounting for nearly 80 percent of total trading volume. By 1996, the largest group was interest rate contracts, accounting for 54 percent of total trading volume. At the same time, agricultural commodities accounted for about 19 percent of total trading volume. According to the exchanges and others, the participants in the futures market have changed as the market evolved. They noted that the participants are now largely institutions and market professionals, with retail customers representing a smaller proportion of total market participants than they did when the act was amended in 1974.

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[17]Commodity options give the purchaser the right, but not the obligation, to buy or sell a specified quantity of the underlying commodity or financial asset at a particular price on or before a certain future date.

[18]CEA section 2(a)(1)(B), which codified the Shad-Johnson Jurisdictional Accord, excludes options on securities from CFTC's jurisdiction. Options on securities are regulated by the Securities and Exchange Commission under federal securities laws.

[19]In CFTC v. Dunn, CFTC brought an enforcement action against an investment fund that was allegedly defrauding its investors through the purchase and sale of currency options, CFTC v. Dunn, 65 U.S.L.W. 4141 (U.S. Feb. 25, 1997), rev'g 58 F. 3d 50 (2d Cir. 1995). The impact of this decision is covered in our discussion of the Treasury Amendment.

During this period, the CEA has remained the primary statute specifically created to regulate the trading of derivative products.

OTC Derivatives and Exchange-Traded Futures Can Be Used as Substitutes for and Complements to Each Other

OTC derivatives and exchange-traded futures have similar characteristics and economic functions but differ in other ways. The market values of both products are determined by the value of an underlying asset, reference rate, or index. The economic uses of both products include hedging financial risk and investing with the intent of profiting from price changes, called speculating. OTC derivatives and exchange-traded futures differ in the way they are traded and cleared as well as in their degree of standardization. OTC derivatives, which include forwards, options, and swaps, are privately negotiated contracts. They are entered into between counterparties, also called principals, outside centralized trading facilities[20] such as futures exchanges. Counterparties negotiate contract terms—such as price, maturity, and quantity—to customize the contracts to meet their specific economic needs. Because OTC derivatives are entered into on a principal-to-principal basis, each counterparty is exposed to credit risk—the risk of loss resulting from the other party's failure to meet its financial obligation. In contrast, futures traditionally have been traded on organized exchanges as well as cleared and settled through clearinghouses. Clearinghouses manage counterparty credit risk, in part by substituting themselves as the buyer to every seller and the seller to every buyer. They also guarantee daily settlement of price changes, thereby eliminating the need for the original counterparties to monitor each other's creditworthiness.[21] Exchange-traded futures generally have standardized terms—except for price, which the market determines.

The exchange-traded futures and OTC derivatives markets have followed similar evolutionary paths. Exchange-traded futures developed from forward grain contracts that were customized and traded on a principal-to-principal basis. They evolved into contracts that have standardized terms, except for price, and are traded on centralized exchanges. Similarly, OTC derivatives originated as customized contracts that involved brokers finding and matching counterparties. Today, almost

[20]Centralized trading facilities are physical or electronic facilities in which all market participants are able to execute transactions simultaneously and bind both parties by accepting offers that are made by one participant but open to all market participants.

[21]Counterparties still face credit risk from the potential failure of their clearinghouse and/or clearing member (a member of the clearinghouse). Also, clearing members face credit risk from their exposure to customers, and customers face credit risk from their exposure to other customers whose funds have been segregated in the same account. In the United States, exchange rules and CFTC regulations provide safeguards to minimize credit risk arising from such sources.

all OTC derivatives are traded through dealers.[22] An industry association has developed standardized documentation for certain OTC derivatives, including swaps. However, each contract, including its material terms, continues to be privately negotiated between the two counterparties. The less complex interest rate and foreign-exchange swaps, called plain vanilla swaps, have become more homogeneous in terms of underlying reference rates or indexes and maturities. The majority of both swaps and exchange-traded futures are settled without delivery of the underlying commodity or financial asset.

Because OTC derivatives and exchange-traded futures serve similar economic functions, they can be used as substitutes for one another and thus may compete in the marketplace. However, they are not perfect substitutes because of potential differences in their contract terms as well as transaction costs, regulations, and other factors. OTC derivatives and exchange-traded futures can also complement each other. For example, swaps dealers use exchange-traded futures to hedge the residual risk resulting from unmatched positions in their swaps portfolios. Similarly, food processors, grain elevators, and other commercial firms use exchange-traded futures to hedge their forward positions.

Scope and Methodology

To address our two objectives, we reviewed the CEA and its legislative history, Federal Register notices, comment letters, and other material related to CFTC's exemptions for hybrid, OTC energy, swaps, and exchange-traded futures contracts. We also interviewed CFTC officials, including past commissioners, about the agency's use of its exemptive authority for OTC derivatives and exchange-traded futures as well as the legal and regulatory issues raised by these markets. Furthermore, we interviewed officials of three futures exchanges (the Chicago Board of Trade, Chicago Mercantile Exchange, and New York Mercantile Exchange), the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission (SEC) to obtain their views concerning legal and regulatory issues related to the exempted OTC derivatives. In addition, we attended conferences and congressional hearings as well as reviewed legal cases, journal articles, books, and reports pertaining to the CEA and the OTC derivatives and exchange-traded futures markets.

[22]Dealers are typically banks and other financial institutions that stand ready to buy or sell OTC derivatives, providing both a bid and offer price to the market.

Although OTC derivatives raise issues that extend beyond the CEA, we limited our review to the legal and regulatory issues raised within the context of the act. Given this focus, our discussion centered on futures, forwards, and swaps and generally did not cover other financial products, including securities options, asset-backed securities, and structured notes, which are regulated under the federal securities laws.

We requested comments on a draft of this report from the heads, or their designees, of CFTC, the Department of the Treasury, the Federal Reserve Board, the Office of the Comptroller of the Currency, and SEC. We also requested comments from three futures exchanges (the Chicago Board of Trade, Chicago Mercantile Exchange, and New York Mercantile Exchange), the New York Stock Exchange, and four industry associations (the Futures Industry Association,[23] International Swaps and Derivatives Association,[24] Managed Futures Association,[25] and National Futures Association[26]). CFTC, the Department of the Treasury, the Federal Reserve Board, and SEC provided us with written comments under a joint response as members of the President's Working Group on Financial Markets. We also obtained written comments from two futures exchanges (the Chicago Mercantile Exchange and Chicago Board of Trade) and the four industry associations. These comments are discussed at the end of this report and are reprinted in appendixes I through VII. We did not receive written comments from the Office of the Comptroller of the Currency, New York Mercantile Exchange, or New York Stock Exchange. In addition, officials from CFTC, the Department of the Treasury, the Federal Reserve Board, the Office of the Comptroller of the Currency, SEC, the International Swaps and Derivatives Association, and the Chicago Mercantile Exchange provided us with technical comments that were incorporated into the report as appropriate. We did our work in Chicago, New York, and Washington, D.C., between August 1994 and February 1997 in accordance with generally accepted government auditing standards.

[23]The Futures Industry Association is the national trade association of the futures industry.

[24]The International Swaps and Derivatives Association is a trade association that represents more than 150 financial institutions worldwide. Its members include investment, commercial, and merchant banks that deal in OTC derivatives contracts.

[25]The Managed Futures Association is a national trade association that represents the managed futures industry. Its members are primarily commodity pool operators and commodity trading advisors. Commodity pool operators are individuals or firms that solicit or accept funds, securities, or property for the purpose of trading commodity futures or options. Commodity trading advisors are individuals or firms that are in the business of advising others, either directly or through publications, on the value or advisability of trading commodity futures or options.

[26]The National Futures Association is a self-regulatory organization that is responsible, under CFTC oversight, for qualifying commodity futures professionals and for regulating the sales practices, business conduct, and financial condition of its member firms.

CFTC Used Its Exemptive Authority to Reduce or Eliminate the Legal Risk Surrounding the Enforceability of Most OTC Derivatives

Before 1993, swaps and other OTC derivatives contracts faced the legal risk of being deemed illegal off-exchange futures and thus unenforceable under the CEA. To reduce this risk and promote innovation and fair competition, Congress granted CFTC exemptive authority under the Futures Trading Practices Act of 1992. CFTC used its authority in 1993 to exempt swaps and other OTC derivatives from most CEA provisions (including the exchange-trading requirement), thereby reducing or eliminating their legal risk. However, a narrow group of swaps that are ineligible for the exemption continue to face the risk of being illegal futures. In addition, certain unregulated forwards have become increasingly difficult to distinguish from regulated futures, resulting in legal risk.

Swaps and Other OTC Derivatives Faced the Risk of Being Illegal and Thus Unenforceable Futures Under the CEA

The CEA excludes forwards and certain other OTC derivatives from its regulation, but many swaps and other OTC derivatives could not qualify for these exclusions. As a result, they faced the risk that CFTC or a court could find them to be illegal and, thus, unenforceable futures under the CEA. To reduce this legal risk, CFTC issued a policy statement in 1989 to clarify the conditions under which it would not regulate swaps as futures. CFTC's policy statement, however, did not eliminate the risk of a court finding swaps to be futures. In 1990, a court found certain OTC derivatives that resembled unregulated forwards to be futures, which heightened the legal risk for swaps and other OTC derivatives. Following the court decision, CFTC issued a statutory interpretation holding that the OTC derivatives in question were forwards, not futures.

Many Swaps Could Not Qualify for an Exclusion From Regulation Under the CEA

Due to their similarities to futures, swaps and other OTC derivatives faced the legal risk of being deemed futures under the CEA, making them illegal and, thus, unenforceable. These contracts were developed in the 1980s to meet the risk-management, financing, and other needs of market participants. Swaps evolved from parallel loans that involved two parties making loans to each other in equal amounts but denominated in different currencies. Over time, swaps were developed based not only on foreign currencies but also on interest rates, commodities, and securities. These contracts, like forwards, were entered into between two counterparties outside an exchange and could be viewed as serving a similar economic function as a series of forwards. However, swaps differed from forwards in that they typically did not entail delivery of the specified underlying commodity, a hallmark of traditional forwards. As such, swaps generally were not considered forwards for regulatory purposes. Consequently, they did not fall under the CEA's forward exclusion[27] (discussed below), which would have excluded them from regulation under the act. Nor did many swaps fall under the CEA's Treasury Amendment[28] (discussed below), which excludes certain OTC transactions in foreign currencies and other financial instruments from regulation under the act.

Swaps that could not qualify for an exclusion from the CEA under its forward exclusion or Treasury Amendment faced the possibility of falling within the judicially crafted definition of a futures contract, because they, like futures, served a risk-shifting function. This possibility resulted in legal risk for such swaps by bringing into question their enforceability as futures under the act. If such swaps were found to be futures, they would be illegal and unenforceable, because they would have been traded off-exchange in violation of the CEA's exchange-trading requirement. Given the legal uncertainty surrounding the status of swaps as futures, swaps counterparties faced legal risk from two sources. First, CFTC could take enforcement action and find swaps to be illegal, off-exchange futures contracts. Second, counterparties on the losing side of swaps could try to have a court invalidate the contracts as illegal, off-exchange futures contracts.

To Reduce Legal Risk for Swaps, CFTC Issued a Policy Statement

To reduce the legal risk of unenforceability in the swaps market, CFTC issued a swaps policy statement in 1989 that clarified the conditions under which it would not regulate certain swaps as futures. In part, CFTC predicated its swaps policy statement on the rationale that swaps lacked certain elements that facilitated futures trading on exchanges, such as standardized terms and a clearinghouse. As such, swaps were not suitable for exchange trading and, in turn, not appropriately regulated as exchange-traded futures contracts. In this regard, CFTC identified conditions (collectively called a safe harbor) that swaps settled in cash could meet to avoid regulation under the CEA. These conditions were that the swaps

- have individually tailored terms,
- be used in conjunction with the counterparty's line of business,
- not be settled using exchange-style offset or a clearinghouse, and
- not be marketed to the general public.

[27]The forward exclusion is set forth in CEA section 2(a)(1)(A)(i). Originally enacted as part of the Grain Futures Act of 1922, it excludes forward contracts from CFTC regulation to facilitate the movement of agricultural commodities through the merchandizing chain.

[28]The Treasury Amendment is set forth in CEA section 2(a)(1)(A)(ii).

CFTC's swaps policy statement did not eliminate all legal risk of unenforceability. It removed the legal risk that CFTC would take enforcement action against certain swaps, but it did not remove the legal risk that a swaps counterparty might try to have a court invalidate a swap as an illegal, off-exchange futures contract. A court finding that a swap was a futures contract could call into question the legality of other swaps—potentially threatening the market's financial integrity and potentially presenting a source of systemic risk.[29]

A Court Found That Certain OTC Derivatives Were Futures, Causing CFTC to Issue a Statutory Interpretation to Reduce Legal Risk

Following the issuance of CFTC's swaps policy statement, a federal district court found that certain OTC energy contracts were futures. This finding heightened the legal risk of unenforceability for swaps and other OTC derivatives because of the possibility that a court could also find them to be futures and subject to the CEA's exchange-trading requirement. Judicial proceedings began in 1986 when commercial participants in the Brent oil market[30] were sued for violating, among other laws, the CEA's antimanipulation provisions. The participants responded by claiming that the contracts were forwards and excluded from the CEA because no contractual right existed to avoid delivery. In April 1990, a federal district court rejected the claim and found that the contracts were futures, not forwards.[31] The court concluded that even though the contracts did not include a contractual right of offset for avoiding delivery, both the opportunity to offset the contracts and the common practice of doing so were sufficient to determine that the contracts were futures. Furthermore, the court found that the Brent oil contracts, like futures, were undertaken mainly to assume or shift price risk without transferring the underlying commodity. The contracts had highly standardized terms, which facilitated their settlement without delivery and reflected their use for risk-shifting or speculative purposes.

On September 25, 1990, CFTC issued a statutory interpretation for forwards that adopted the view that the Brent oil contracts were forwards, not futures. CFTC did not dispute the court's findings that these contracts were highly standardized and routinely settled by means other than delivery. Rather, it found that the contracts fell under the CEA's forward exclusion

[29]Systemic risk is the risk that a disruption—at a firm, in a market, or from another source—will cause difficulties at other firms, in other market segments, or in the financial system as a whole.

[30]Brent oil contracts are for the future purchase or sale of Brent crude oil, which is a blend of oils produced in various fields in the North Sea and delivered through pipelines for loading on cargo ships at Sullem Voe in Scotland.

[31]Transnor (Bermuda) Limited v. BP North America Petroleum, 738 F. Supp. 1472 (S.D.N.Y. 1990).

because they required the commercial parties to make or take delivery, even though the parties did not routinely do so. CFTC noted that the contracts did not include any provisions that enabled the parties to settle their contractual obligations through means other than delivery, and the settlement of contracts without delivery was done through subsequent, separately negotiated contracts. In that regard, CFTC noted that these contracts served the same commercial function as forwards covered under the CEA exclusion, notwithstanding the fact that many of the individual contracts were settled routinely without delivery. One CFTC commissioner dissented from the agency's statutory interpretation, which, he said, misinterpreted the CEA exclusion by broadening it to include transactions that were, among other things, generally standardized, used for noncommercial purposes, and offset.

Congress Granted CFTC Exemptive Authority to Reduce the Legal Risk Facing Swaps and Other OTC Derivatives

Following the court's finding that certain OTC energy contracts were futures and recognizing the broader implications of that decision for other OTC derivatives, Congress granted CFTC exemptive authority under the Futures Trading Practices Act of 1992. The 1992 act granted CFTC the authority to exempt any contract from almost all CEA provisions (including the exchange-trading requirement), provided the exemption was consistent with the public interest[32] and the contract was entered into solely between appropriate persons, as defined in the act. In granting an exemption, CFTC could impose any conditions on the exemption that it deemed appropriate. The only provision from which CFTC could not exempt a contract was section 2(a)(1)(B), which generally prohibits futures contracts on individual stocks and narrowly based stock indexes.[33]

According to the 1992 act's legislative history, Congress expected CFTC to use its exemptive authority promptly to reduce legal risk for swaps,

[32]According to the legislative history, the public interest was to include the national public interest noted in the CEA (discussed in section 3 of the act), prevention of fraud, preservation of the financial integrity of the markets, and promotion of responsible economic or financial innovation and fair competition.

[33]The section provides procedures under which CFTC, subject to SEC's review, may permit exchanges to trade futures contracts on stock indexes provided minimum criteria are met. These criteria include that the contract is settled other than through delivery of the underlying securities and the underlying index of securities is broadly based.

forwards,[34] and hybrids.[35] The legislative history noted that the goal of providing CFTC with broad exemptive authority was to give CFTC a means of providing certainty and stability to existing and emerging markets so that financial innovation and market development could proceed in an effective and competitive manner. It also noted that CFTC could exempt a contract without first determining that the contract was a futures contract and subject to the act.

CFTC Used Its Authority to Exempt Most Swaps and Other OTC Derivatives From Most CEA Provisions

Using its exemptive authority, CFTC exempted a broad group of swaps as well as hybrids from virtually all CEA provisions—including the exchange-trading requirement—in January 1993. In response to a request by a group of commercial firms in the energy market, CFTC granted a similar exemption in April 1993 to specified OTC energy contracts, which included Brent oil contracts. These exemptions eliminated the legal risk that the qualifying contracts could be deemed illegal, off-exchange futures contracts. If CFTC or a court found an exempted contract to be a futures contract, the contract would still be legal, because it would no longer need to be traded on a designated market, or exchange. As a result, uncertainty was reduced and with it, the potential for any related systemic risk. At that time, CFTC noted that the exemptions should enhance U.S. market participants' ability to innovate by enabling them to structure OTC contracts to best meet their economic needs, which should enable market participants to compete more effectively in international markets. In granting its exemptions, CFTC did not determine that the OTC derivatives covered by the exemptions were or were not futures or otherwise excluded from the act's jurisdiction. CFTC noted that it had not made and was not obligated to make such a determination.

A Narrow Group of Swaps Not Eligible for the Exemption Face the Risk of Being Illegal Futures

CFTC's swaps exemption does not extend to a narrow group of swaps, so-called equity swaps.[36] Because of the possibility that swaps are futures, these nonexempted swaps continue to face the legal risk of being deemed illegal and, thus, unenforceable futures. CFTC enforcement actions involving OTC derivatives can increase such legal risk for these swaps.

[34]In elaborating on the forward exemption in the act's legislative history, Congress encouraged CFTC to determine whether exemptive or other action should be taken for Brent Oil contractsn.

[35]Hybrids are financial instruments that possess, in varying combinations, characteristics of futures, forwards, options, securities, and/or bank deposits. Unlike many other derivatives, hybrids generally serve a capital-raising function.

[36]In addition, CFTC's exemption does not extend to swaps based on securities registered with SEC—such as swaps based on registered corporate debt. To the extent that such swaps exist, the following discussion on equity swaps applies to them.

CFTC's Swaps Exemption Does Not Cover All Swaps

CFTC's swaps exemption does not extend to equity swaps, whose returns are based on stocks or stock indexes. Even if these swaps met all of the conditions of CFTC's swaps exemption, they would not be exempt from CEA section 2(a)(1)(B), which codified the Shad-Johnson Jurisdictional Accord. Under the 1992 act, CFTC is allowed to exempt swaps from any CEA provision, except section 2(a)(1)(B), which divides jurisdiction on exchange-traded securities-related futures and options contracts between CFTC and SEC and prohibits futures on individual stocks or narrowly based stock indexes. Futures on broadly based stock indexes may be traded only on CFTC-designated markets, provided CFTC determines that the contracts are not settled through the delivery of the underlying stocks and are not readily susceptible to manipulation. SEC must also agree with CFTC's determinations. According to market observers, if equity swaps were found to be futures contracts, they could be in violation of section 2(a)(1)(B) and thus be illegal and unenforceable.

As long as the issue of whether swaps are futures is not definitively addressed by CFTC, the courts, or Congress, the possibility exists that equity swaps could be found to be futures and, thus, subject to the CEA. CFTC has noted, however, that market participants using equity swaps may continue to rely on its 1989 swaps policy statement. As discussed earlier, the policy statement removed the legal risk that CFTC would take enforcement action against certain swaps, but it did not remove the risk that a court could invalidate such contracts by deeming them to be illegal futures. In addition, the legal enforceability of equity swaps could be jeopardized indirectly through a finding that an exempted swap is a futures contract. For example, CFTC had proposed amending its swaps exemption to include a stand-alone, antifraud rule that would apply to exempted swaps.[37] According to other federal regulators and market participants commenting on the proposal, the rule would have suggested that the exempted swaps were futures. This, in turn, would have suggested that equity swaps were also futures. Following the comment period, CFTC did not amend its swaps exemption to include the proposed change.

According to the International Swaps and Derivatives Association, a finding that an exempted swap is a futures contract could increase legal risk by prompting losing counterparties to equity swaps to rely on the resulting legal uncertainty to avoid their performance obligations under such contracts. It noted that this could result in substantial losses and a market disruption. At a June 1996 hearing held by the Senate Committee

[37]According to CFTC, questions had been raised about the applicability of the CEA's antifraud provisions to exempted swaps, and the proposed stand-alone, antifraud rule would have eliminated such questions.

on Agriculture, Nutrition and Forestry, the association testified that the legal risk surrounding equity swaps has inhibited their evolution and that this uncertainty needs to be addressed. The Bank for International Settlements estimated that the worldwide market for equity swaps and forwards had a total notional value of $52 billion, as of March 31, 1995, which accounted for less than 1 percent of the total notional value of the OTC derivatives market.[38]

CFTC Enforcement Actions Involving OTC Derivatives Have Raised Questions About the Enforceability of Equity Swaps

CFTC's enforcement actions involving OTC derivatives have highlighted the potential for such action to increase legal risk in the equity swaps market. In December 1994, CFTC and SEC cooperated in an enforcement action against BT Securities, a swaps dealer, for violating antifraud provisions of futures and securities laws in connection with swaps it sold.[39] CFTC officials told us that swaps market participants did not want the agency to take any action against the swaps dealer that would suggest swaps were futures for fear of increasing legal risk for equity swaps. In its enforcement order, CFTC did not identify any of the swaps as futures. Rather, it found that BT Securities violated the CEA's antifraud provisions in its role as a commodity trading advisor by providing the counterparty with misleading information about the swaps. According to market participants and observers, the finding implied that certain of the swaps sold by BT securities were futures or commodity options, which raised questions regarding the status of swaps under the CEA. Recognizing the potential legal and regulatory implications, CFTC issued a news release stating that its actions did not affect the legal enforceability of swaps or signal an intent to regulate them.

According to some market participants and observers, CFTC's enforcement order against MG Refining and Marketing—a commercial firm—resulted in greater legal risk for forwards and equity swaps. In 1995, CFTC took enforcement action against MG Refining and Marketing for selling illegal, off-exchange futures to commercial counterparties. The firm sold contracts that purportedly required the delivery of energy commodities in the future at a price established by the parties at initiation. These contracts provided counterparties with a contractual right to settle the contracts in cash without delivery of the underlying commodity. This right could be invoked if the price of the underlying commodity reached a preestablished level. Based largely on this provision, CFTC found these

[38]The Bank for International Settlement reported the total notional amount outstanding of equity swaps and forwards together.

[39]BT Securities is registered with SEC as a broker-dealer. SEC found that certain of the OTC derivatives that BT Securities sold were securities within the meaning of the federal securities laws.

contracts to be illegal, off-exchange futures. CFTC's conclusion was consistent with prior court and CFTC decisions; it identified the contractual right to offset as a critical feature distinguishing forwards from futures. Nonetheless, some market participants and observers asserted that CFTC's order broadened the definition of a futures contract, creating legal uncertainty over whether swaps and other OTC derivatives are futures and resulting in greater legal risk for forwards and equity swaps.

In a letter sent to CFTC, two U.S. congressmen expressed their concern about the potential for CFTC's enforcement order to bring into question the status of swaps as futures and to reflect a change in CFTC's regulatory position on swaps. In response to the congressional inquiry, the then CFTC chairman wrote that the case had nothing to do with swaps. She noted that, with regard to swaps generally, CFTC had not taken a position on whether swaps were futures and continued to adhere to its 1989 swaps policy statement. She also noted that in this case CFTC did not deviate from its historical practice of looking at the totality of the circumstances—including the nature of the contract and market—in determining whether a particular transaction involved a futures contract.

On February 4, 1997, Senator Lugar, Chairman of the Senate Agriculture Committee, Senator Harkin, Ranking Minority Member, and Senator Leahy introduced a bill to amend the CEA. The bill is similar to the one that Senators Lugar and Leahy introduced in the Fall of 1996, following the June 1996 hearing. As noted in a discussion document prepared by Senators Lugar and Harkin, the bill would provide greater legal certainty for equity swaps by codifying the existing swaps exemption and extending the exemption's scope to include equity swaps.

Certain Forwards Have Evolved to Where It Has Become Increasingly Difficult to Distinguish Them From Futures, Resulting in Legal Risk

Forwards have been distinguished from futures based on whether the parties intended to make or take delivery of the underlying commodity when they entered into the contract. However, certain unregulated forwards have evolved to where delivery of the underlying commodity may not routinely occur, making it increasingly difficult to distinguish them from regulated futures and resulting in the legal risk that they could be unenforceable. The CEA does not provide clear criteria for distinguishing forwards from futures, but CFTC's exemptions reduce the need to do so for the purpose of addressing legal risk.

Forwards Traditionally Differed From Futures in That They Entailed Delivery

As discussed above, since its enactment in 1936, the CEA has excluded forward contracts from its regulation to facilitate the movement of commodities through the merchandizing chain.[40] Absent a definition of a forward contract in the CEA, CFTC and the courts have generally defined these contracts in reference to futures contracts. Traditionally, they distinguished forwards from futures based on whether the parties intended to make or take delivery of the underlying commodity when they entered into the contract. Forwards served primarily a commercial function and, as such, entailed delivery of the underlying commodity in normal commercial channels, but delivery was to occur at a later date. In contrast, futures were used primarily to shift or assume price risk without transferring the underlying commodity; thus, actual delivery was not expected to occur. In short, CFTC and the courts defined a forward as a contract that bound one party to make delivery and the other to take delivery of the contract's underlying physical commodity. Since forwards were commercial transactions that resulted in delivery, CFTC and the courts looked for evidence of the contracts' use in commerce. In particular, they examined whether the parties were commercial entities that could make or take delivery and whether delivery routinely occurred.

Certain Forwards Face the Legal Risk of Being Unenforceable

Besides the Brent oil market, other forward markets are evolving in response to the risk-management and commercial needs of their participants. For example, changes in U.S. farm policy, increased globalization of the agricultural markets, and other factors may have increased price volatility in the agricultural markets and created a demand for more innovative risk-management contracts. According to agricultural market participants, traditional forwards do not provide producers with sufficient flexibility because of their delivery requirement. In response to participants' needs, the forward market for agricultural commodities has evolved to include variations of forwards that may not routinely result in delivery. Contracts that routinely allow parties to offset, cancel, or void delivery obligations rather than transfer the underlying commodity may be viewed as futures contracts or trade options, depending on their pricing structure. CFTC permits the sale of trade options on nonagricultural commodities, but prohibits the sale of such options on domestic

[40]For example, a producer and grain elevator would enter into a forward contract under which the grain elevator would agree to buy the producer's grain before it was harvested. The sale price was agreed to when the contract was initiated, and both parties expected that the grain would be delivered when harvested. In entering the forward contract, the producer would shift the price risk incident to the farming operation to the elevator.

agricultural commodities.[41] This prohibition was intended, in part, to protect producers from unscrupulous parties who might try to take advantage of their lack of knowledge about these options.

One variation of a forward experiencing increased use is the hedge-to-arrive contract. Although varying in design, these are privately negotiated contracts in which a producer agrees with an elevator to deliver grain on a future date at an agreed-upon price,[42] and the elevator uses exchange-traded futures to hedge the sale on behalf of the producer. Some of these contracts have allowed producers to defer the delivery dates on their contracts beyond the current crop year, which has exposed producers to significant price risk because their contracts were no longer tied to the current crop year. According to market observers, unusual factors, such as high grain prices and poor weather conditions, have resulted in financial problems for some parties that deferred delivery into future crop years. In May 1996, CFTC staff issued a policy statement for hedge-to-arrive contracts to allow counterparties experiencing losses to settle their contracts without delivery by entering into subsequent, separately negotiated contracts. CFTC noted that it would not find hedge-to-arrive contracts existing as of May 15, 1996, to be illegal based solely on the cash settlement of such contracts for the purpose of unwinding them, but may find them to be illegal based on other factors.[43]

CFTC or a court could find some hedge-to-arrive contracts or other variations on agricultural forwards to be futures or agricultural trade options. Either finding would make them illegal and unenforceable, provided the contracts did not qualify for the swaps exemption. For example, in November 1996, CFTC filed three administrative complaints, two of which alleged, among other things, that two elevators had offered and sold hedge-to-arrive contracts that were illegal, off-exchange futures. In these two complaints, CFTC noted that the elevators sold the hedge-to-arrive contracts to some producers who lacked the intent or capacity to make delivery of the grain. CFTC also noted some producers did not qualify as eligible participants under the swaps exemption. CFTC

[41]In December 1995, CFTC held a roundtable discussion to address the possibility of lifting its ban on agricultural trade options to provide producers with a broader range of marketing and risk-management tools. Based on this discussion, CFTC staff expected to advise the agency's commissioners of those issues that require further analysis.

[42]The final price received for the commodity being sold is determined by a formula that references the current and future price of a specified exchange-traded futures contract as well as the future market price of the commodity.

[43]According to CFTC, the actual delivery of the underlying physical commodity (as opposed to offset) has been a hallmark of traditional agricultural forwards, but the failure to deliver on a contract alone would not necessarily preclude the contract from qualifying for the forward exclusion.

further noted that the contracts contained a cancellation provision that permitted producers to effect an offset of their contracts.

The CEA Does Not Provide Clear Criteria for Distinguishing Forwards From Futures

While the CEA excludes forwards from its regulation because of their commercial merchandizing purpose, it does not provide clear criteria for distinguishing forwards from futures. In particular, the CEA does not specify what constitutes delivery under the forward exclusion and, thus, when a forward becomes a futures contract. Given the lack of clear criteria, the evolution of certain forwards to where delivery may not routinely occur has made it increasingly difficult to distinguish unregulated forwards from regulated futures. As illustrated by the Brent oil and hedge-to-arrive contracts, the difficulty in distinguishing between forwards and futures can result in legal risk. Under its 1990 statutory interpretation for forwards (discussed above), CFTC tried to reduce the legal risk and regulatory constraints that forwards face because of the delivery requirement, thereby permitting them to evolve to better meet the economic needs of end-users. However, its interpretation does not provide a clear basis for distinguishing forwards from futures in terms of their economic purpose. For example, it does not preclude forwards from being settled routinely without delivery and, in the process, being used primarily for risk-shifting or speculative purposes instead of a commercial merchandizing purpose.

CFTC's Exemptions Reduce the Need to Distinguish Forwards From Futures for the Purpose of Addressing Legal Risk

CFTC's exemptions for OTC energy and swaps contracts reduce the need to distinguish unregulated forwards from regulated futures for the purpose of addressing the legal risk of being unenforceable. CFTC's OTC energy contract exemption reduces legal risk for certain forwards that routinely settle without delivery, but it is limited to OTC derivatives based on specified energy products. Although the exemption covers Brent oil contracts that CFTC determined earlier to be forwards under its 1990 interpretation, CFTC noted that the exemption does not affect its interpretation. However, as with its 1989 swaps policy statement, CFTC's forward interpretation does not eliminate all legal risk. It removes the legal risk of CFTC taking enforcement action against a contract that is consistent with its interpretation, but it does not eliminate the risk of a counterparty trying to have a court invalidate the contract as an illegal, off-exchange futures contract.

CFTC's swaps exemption further reduces the need to distinguish unregulated forwards from regulated futures to address legal risk. Contracts that resemble forwards but do not entail delivery may qualify for the swaps exemption. Qualifying contracts would not be illegal and unenforceable, even if CFTC or a court found them to be futures, because they would be exempt from the exchange-trading requirement. The swaps exemption is limited to "eligible" participants, which are largely institutional and other sophisticated market participants. Consequently, the exemption generally does not extend to contracts that involve unsophisticated market participants.

Issues Remain Related to the Appropriate Regulation for the OTC Derivatives and Exchange-Traded Futures Markets

Notwithstanding CFTC's success in reducing or eliminating the legal risk of unenforceability that most OTC derivatives faced, issues remain that raise a broader policy question about the appropriate regulation for OTC derivatives and exchange-traded futures, including their markets and market participants. Congress alluded to this topic in the legislative history of the Futures Trading Practices Act of 1992 by noting that the growth and proliferation of OTC derivatives raises questions of how best to regulate the new market, adding that studies by us and others would be useful when Congress considers the broader question of regulatory policy. To that end, we discuss, but do not attempt to resolve, three issues that are related to the question of how best to regulate the OTC derivatives and exchange-traded futures markets. These issues concern the (1) appropriate regulation for the OTC foreign-currency market under the Treasury Amendment, (2) appropriate regulation for the evolving swaps market,[44] and (3) rationalization of regulatory differences between the OTC derivatives and exchange-traded futures markets.

The Appropriate Regulation for the OTC Foreign-Currency Market Under the Treasury Amendment Is an Unresolved Issue

The CEA excludes, among other things, certain OTC foreign-currency transactions from CFTC regulation under its Treasury Amendment. However, the scope of the amendment has been difficult to interpret and the subject of considerable debate and litigation. CFTC has interpreted the amendment to exclude from the act's regulation certain OTC foreign-currency transactions between sophisticated participants, but not similar transactions involving unsophisticated participants. The Treasury Department has disagreed with CFTC's interpretation. While the federal courts have differed in their interpretation of the Treasury Amendment, they have recognized congressional intent to exclude the interdealer OTC foreign-currency market from regulation under the CEA.

[44]Our discussion focuses on the exempted swaps market, but the broader question of how best to regulate the OTC derivatives market also applies to the equity swaps and evolving forwards markets that are discussed above.

The Treasury Amendment Excludes Certain OTC Foreign-Currency Transactions From CFTC Regulation, but It Is Difficult to Interpret

The Treasury Amendment excludes from CFTC regulation certain OTC transactions in, among other things, foreign currencies and government securities.[45] During the debate over the 1974 amendments to the CEA, the Treasury Department expressed concern that the proposed changes—namely the expansion of the commodities covered under the act coupled with the exchange-trading requirement—would prohibit banks and other financial institutions from trading among themselves in foreign currencies and certain financial instruments, including government securities. The Treasury Department noted that futures trading in foreign currencies was done through an informal network of banks and dealers (called the interbank market),[46] which serves the needs of international business to hedge risk stemming from foreign-exchange rate movements. The Treasury Department proposed the Treasury Amendment as a means of clarifying that the CEA did not cover this market, and Congress adopted the proposed amendment. According to the act's legislative history, Congress noted that the interbank market was more properly supervised by the bank regulators and, therefore, regulation under the CEA was unnecessary.

The Treasury Amendment has been difficult to interpret because its language is ambiguous. Although the amendment was motivated primarily by concern that the interbank foreign-currency market should be excluded from regulation under the act, its language is not limited to the interbank market. Rather, it excludes any transaction in, among other things, foreign currencies, unless the transaction involves sale for future delivery conducted on a board of trade.[47] Before the recent U.S. Supreme Court decision in Dunn v. CFTC, considerable debate occurred over the meaning of the phrase "transactions in," which defines the scope of the exclusion. Arguments were made that the phrase could be interpreted narrowly to mean only cash transactions in the subject commodity or broadly to encompass derivatives transactions such as futures or option contracts. In

[45]The Treasury Amendment states: "Nothing in this Act shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade. (Emphasis added.) The CEA reference to "transactions involving the sale for future delivery" refers to futures contracts and has been interpreted by the U.S. Supreme Court to also refer to commodity options.

[46]The interbank market includes not only banks but also other financial institutions and industrial corporations. Because the market is not limited to banks, some market observers, including the Treasury Department, have noted that the market is more accurately characterized as an "institutional market."

[47]As noted above, the U.S. Supreme Court found that both futures and options involve sale for future delivery within the meaning of the Treasury Amendment.

Dunn, the U.S. Supreme Court endorsed the broader interpretation. Furthermore, the CEA defines the term "board of trade," which is used in the "unless" clause, to "mean any exchange or association, whether incorporated or unincorporated, of persons who shall be engaged in the business of buying or selling any commodity." Consequently, this clause could be interpreted to save from the exclusion virtually any futures or option contract sold by a dealer, a construction that would render the amendment meaningless. The ambiguity of the statutory language has led to disagreements among regulators and courts over how the amendment ought to be interpreted.

CFTC and the Treasury Department Have Interpreted the Treasury Amendment Differently

Because of its significant market impact, the activity that the Treasury Amendment excludes from regulation under the CEA has been the subject of considerable debate among federal regulators. Since at least 1985, CFTC has interpreted the Treasury Amendment to exclude from the act's regulation certain OTC transactions between banks and other sophisticated institutions, drawing a distinction between sophisticated market participants and unsophisticated market participants who may need to be protected by government regulation.[48] An OTC foreign-currency transaction, such as a foreign-exchange swap, sold to a financial institution would be excluded from the act's regulation; a similar contract sold to the general public would not be excluded. CFTC drew this distinction to preserve its ability to protect the general public from, among other things, bucket shops engaging in fraudulent futures transactions—one of its missions under the CEA. According to CFTC, since 1990, the agency has brought 19 cases involving the sale of foreign-currency futures or options contracts to the general public;[49] in those cases, more than 3,200 customers invested over $250 million, much of which was lost. Whether foreign-currency contracts sold to the general public are excluded by the Treasury Amendment, however, has remained a source of legal uncertainty. According to CFTC, if the amendment were interpreted to cover contracts sold to the general public, the agency's ability to prohibit the fraudulent activities of bucket shops dealing in foreign-currency contracts would be effectively eliminated, creating a regulatory gap.

The Treasury Department, however, has objected that CFTC's approach to the Treasury Amendment lacks a foundation in the language of the statute. It has advocated the reading of the Treasury Amendment adopted by the

[48] 50 Fed. Reg. 42983.

[49] One approach that CFTC uses to shut down bucket shops is to show that the contracts they sold were illegal, off-exchange futures, thereby obviating the need to show fraud.

U.S. Supreme Court in Dunn—that is, the Treasury Amendment excludes from CFTC jurisdiction any transaction in which foreign currency is the subject matter, including foreign-currency options, unless conducted on a board of trade. Nevertheless, it has expressed sympathy with CFTC's concerns over fraudulent foreign-currency contracts marketed to the general public. The Treasury Department has suggested that CFTC may be able to interpret the term "board of trade" in a carefully circumscribed manner that would allow appropriate enforcement action against fraud without raising questions about the validity of established market practices.

Federal Court Interpretations of the Treasury Amendment Have Differed

The federal courts have differed in their interpretation of what activity the Treasury Amendment excludes from regulation under the CEA. In spite of these differences, the courts have recognized congressional intent to exclude the interdealer foreign-currency market from regulation. However, past court cases have highlighted the legal confusion over whether the Treasury Amendment excludes from the act's regulation transactions in foreign currencies that involve the general public.

The Second Circuit Court of Appeals held in Dunn that option contracts are not covered by the Treasury Amendment and, therefore, are subject to CFTC jurisdiction. In doing so, it followed a precedent that it had established in a case involving the sale of currency options to private individuals. In that case, it reasoned that an option contract does not become a transaction in foreign currency that is excluded under the Treasury Amendment until the option holder exercises the contract.[50]

In February 1997, the U.S. Supreme Court reversed the Second Circuit's decision in Dunn. The Court interpreted the "transactions in" language of the Treasury Amendment to exclude from CFTC regulation all transactions relating to foreign currency, including foreign-currency options, unless conducted on a board of trade. The Court noted that the public policy issues raised by the various parties affected by the decision were best addressed by Congress.

The Fourth Circuit Court, in Salomon Forex, Inc. v. Tauber,[51] held that sales of currency futures and options to a very wealthy individual are transactions in foreign currency that the Treasury Amendment excludes from regulation. The buyer of the contracts brought the action to avoid

[50]See CFTC v. The American Board of Trade, 803 F. 2d 1242 (2d Cir. 1986), cited in CFTC v. Dunn, 58 F. 3d 50 (2d Cir. 1995), rev'd 65 U.S.L.W. 4141 (U.S. Feb. 25, 1997).

[51]Salomon Forex, Inc. v. Tauber, 8 F. 3d 966 (4th Cir. 1993), cert. denied, 114 S. Ct. 1540 (1994).

payment on transactions in which he had lost money. The court interpreted the amendment to exclude from the CEA individually negotiated foreign-currency option and futures transactions between sophisticated, large-scale currency traders. The court observed that the case did not involve mass marketing of contracts to small investors and stated that its holding did not imply that such marketing was exempt from the CEA.

The Ninth Circuit Court, in CFTC v. Frankwell Bullion Ltd.,[52] affirmed a lower court holding that the Treasury Amendment excludes the sale of off-exchange foreign-currency futures and options from the CEA without regard to whom the contracts are sold. CFTC brought action to stop the seller of the contracts from allegedly selling illegal, off-exchange futures contracts to the general public. The Ninth Circuit Court's review focused on the meaning of the clause "unless . . . conducted on a board of trade." The court interpreted the clause to carve out of the exclusion only contracts sold on an organized exchange. The court acknowledged that the plain meaning of a board of trade as defined by the act would include more than exchanges. But the court rejected this interpretation in the context of the Treasury Amendment because it would cause the "unless" clause to encompass the entire exclusion and thereby render the amendment meaningless. Turning to congressional reports accompanying the 1974 legislation to explain the purpose of the Treasury Amendment, the court concluded that Congress intended to exclude from the CEA all transactions in the listed commodities except those conducted on an organized exchange. In December 1996, CFTC filed a petition with the Ninth Circuit Court requesting a rehearing, which was denied.

At the June 1996 hearing held by the Senate Committee on Agriculture, Nutrition and Forestry, the then acting CFTC chairman testified that the agency and Treasury Department were working to clarify the treatment of foreign-currency transactions under the Treasury Amendment, but that reaching an accord would take time. At the hearing, two futures exchanges testified that congressional action was needed to clarify the Treasury Amendment's scope, particularly in view of the U.S. Supreme Court's decision to review the Dunn case. They said that a court finding that the amendment excludes all off-exchange futures and options on foreign currencies could shift such business away from the exchanges to the less regulated OTC market and adversely affect their competitiveness.

[52]CFTC v. Frankwell Bullion Ltd., 99 F. 3d 299 (9th Cir. 1996).

As mentioned earlier, Senators Lugar, Harkin, and Leahy introduced a bill in February 1997 to amend the CEA. The bill includes a provision to clarify the scope of the Treasury Amendment.[53] According to a discussion document prepared by Senators Lugar and Harkin, the bill reflects the view that a federal role is needed in the market to protect retail investors from abusive or fraudulent activity in connection with the sale of foreign currency futures and options by unregulated entities. The discussion document further notes that under the bill CFTC has no jurisdiction over retail transactions that are subject to oversight by other federal regulators or nonretail transactions.

On January 21, 1997, Congressman Ewing, Chairman of the House Subcommittee on Risk Management and Specialty Crops, introduced a bill to amend the CEA. The bill is identical to the one that he introduced in the Fall of 1996. It proposes, among other things, to amend the Treasury Amendment to clarify that CFTC has regulatory authority only over standardized contracts sold to the general public and conducted on a board of trade. The bill defines board of trade in the context of the Treasury Amendment as "any facility whereby standardized contracts are systematically marketed to retail investors."

The Appropriate Regulation for the Evolving Swaps Market Is an Unresolved Issue

The potential for the exempted swaps market to evolve beyond the conditions of the swaps exemption raises the issue of how to accommodate market developments and address attendant risks and other regulatory concerns. CFTC imposed conditions on exempted swaps that prohibited them from being traded and cleared in the same ways as exchange-traded futures—on a centralized trading facility and through a clearinghouse. Since then, the swaps market has continued to develop, becoming more liquid[54] and transparent.[55] Among other alternatives, CFTC could use its exemptive authority to accommodate any development that is inconsistent with the conditions of the existing exemption—for example, the development of a clearinghouse—and address any attendant

[53]As discussed, Senators Lugar and Leahy introduced a bill to amend the CEA in the Fall of 1996. Rather than addressing the Treasury Amendment in that bill, the senators asked CFTC and the Treasury Department to reach an agreement by the end of 1996 on how the amendment should be interpreted and, if necessary, amended. While the agencies were unable to reach an agreement by that time, they have continued their discussions. In the meantime, each agency has provided the senators with differing language to amend the Treasury Amendment. The bill that Senators Lugar, Harkin, and Leahy recently introduced does not fully adopt either agency's proposed language.

[54]Liquidity is the extent to which market participants can buy and sell contracts without changing the market's price.

[55]Transparency is the extent to which information about prices, trading volume, and trades is disseminated to the public.

risks to the market. However, such an approach could prompt legal challenges and raise jurisdictional questions.

CFTC Exempted Certain Swaps From the CEA Subject to Four Conditions

CFTC's swaps exemption allows exempted swaps to trade legally outside regulated exchanges—free from all CEA provisions, except certain antifraud and antimanipulation provisions,[56] and free from all CFTC regulations. In granting the swaps exemption, CFTC did not take a position on whether exempted swaps were futures contracts and subject to the CEA's jurisdiction. CFTC noted that it had not made and was not obligated to make such a determination.

CFTC specified four conditions that swaps had to meet to qualify for an exemption. First, they had to be entered into solely by eligible participants, namely institutional and other sophisticated market participants. Eligible participants include banks, securities firms, insurance companies, commercial firms meeting minimum net worth requirements, and individuals meeting minimum total asset requirements. Second, they could not be fungible with standardized, material economic terms. Third, the creditworthiness of the counterparties had to be a material consideration. With this condition, exempted swaps could not be cleared, like exchange-traded futures, through a clearinghouse.[57] Fourth, they could not be entered into and traded on or through a multilateral execution facility, such as a futures exchange.

According to CFTC, these four conditions were intended to reflect the way that swaps transactions occurred in 1993 when the exemption was granted and to draw a line at which such transactions would not raise significant regulatory concerns under the CEA. CFTC officials told us that Congress directed the agency to exempt swaps as they were then transacted to provide them with legal certainty. In addition, the four conditions distinguished the exempted swaps from exchange-traded futures for regulatory—not legal—purposes. That is, the exemption excluded from regulation under the CEA swaps that did not possess certain characteristics common to exchange-traded futures; it did not establish that exempted swaps were not futures or otherwise excluded from the act's jurisdiction. The conditions generally reflected the elements that facilitate futures

[56]These antifraud and antimanipulation provisions are limited to specified types of conduct that involve futures, options, or the cash market.

[57]According to the swaps exemptive release (58 Fed. Reg. 5591), "the exemption does not extend to transactions subject to a clearing system where the credit risk of individual members of the system to each other in a transaction to which each is a counterparty is effectively eliminated and replaced by a system of mutualized risk of loss that binds members generally whether or not they are counterparties to the original transaction."

trading on an exchange, including standardized units, a clearinghouse, and open and competitive trading in a centralized market. As CFTC and the courts have noted, these elements developed in conjunction with the growth of the futures market to facilitate futures trading on exchanges; however, their presence or absence does not necessarily determine whether a contract is a futures contract.

CFTC and others (including federal regulators and market observers) have acknowledged that a centralized trading facility and/or clearinghouse could benefit the swaps market and general public. For example, such facilities could increase the market's liquidity and transparency and enhance the market's financial integrity. In its 1993 exemptive release for swaps, CFTC noted that such facilities did not yet exist and their existence would present different regulatory issues than are raised under the current swaps exemption. Recognizing the potential benefits of such facilities, CFTC left open the opportunity for market participants to develop and use such facilities, provided that such facilities receive CFTC's prior approval.

As discussed, Senators Lugar, Harkin, and Leahy recently introduced a bill to amend the CEA that includes a provision to codify the existing swaps exemption. As noted in the discussion document prepared by Senators Lugar and Harkin, the provision would not affect CFTC's power to grant additional exemptions or to amend the existing exemption to make it less restrictive. However, the provision would require a statutory change to make the existing swaps exemption more restrictive. According to market observers, the provision addresses the concern of OTC market participants that CFTC could modify the swaps exemption in a way that could disrupt the market. At a February 11, 1997, hearing held by the Senate Committee on Agriculture, Nutrition and Forestry, CFTC testified against the provision, noting that it would eliminate the agency's ability to modify the existing swaps exemption in response to market developments.

The Swaps Market Has Continued to Develop Under the Exemption

Under the swaps exemption, the swaps market has become more liquid and transparent. Swaps are traded primarily through dealers, some of whom are linked through electronic communication networks that allow them to exchange price information and negotiate transactions.[58] Swaps are commonly executed using standardized documentation, but each contract—including its material terms—continues to be privately negotiated between two counterparties. As mentioned above, plain vanilla interest rate and foreign-exchange swaps have become more

[58]Under the swaps exemption, swaps market participants may use electronic facilities "to communicate simultaneously with other participants, so long as they do not use such facilities to enter orders to execute transactions" (58 Fed. Reg. 5591).

homogeneous, with dealers providing "indicative" (nonbinding) quotes for such swaps. Market participants have noted that the market for plain vanilla interest rate swaps has become very liquid and transparent, with pricing information readily available from independent sources. Increased liquidity and transparency can facilitate the use of offsetting contracts to terminate open contracts.[59]

Some swaps market participants are increasingly using practices that are similar, but not identical, to those used in the exchange-traded futures market to reduce credit and other risks. These practices may reduce systemic risk and encourage greater market efficiency. Some swaps participants are using bilateral netting, which is the combining of payment obligations arising from multiple transactions with one counterparty into one net payment. In addition, some are periodically determining the value of their swaps using market values, called marking-to-market. This practice facilitates the movement of collateral, such as cash or U.S. government securities, to reduce the financial exposure of counterparties from open contracts.

In comparison, exchanges reduce credit risk by collecting margin (payment required on open contracts that decline in value) on at least a daily basis and by interposing a clearinghouse as the guarantor of all contracts. As discussed above, in each exchange-traded futures transaction, the clearinghouse is substituted for the original parties, becoming the buyer to every seller and the seller to every buyer. Through this process, the clearinghouse assumes the credit risk of each transaction and mutualizes it among all clearing members. While swaps market participants do not use clearinghouses, two futures exchanges are developing collateral depositories to help manage swaps positions and collateral for OTC market participants. Unlike a clearinghouse, they would not guarantee contract performance. One exchange has reported that it is developing exchange-traded swaps and plans for its depository to ultimately guarantee their performance.

CFTC Could Use Its Exemptive Authority to Accommodate Swaps Market Developments

Although difficult to predict, the swaps market might develop in ways that are inconsistent with the conditions of the existing swaps exemption. Such developments could present risks to the market that warrant greater federal regulation to protect the public interest. An example of such a

[59]A swap can be offset by entering into an equal but opposite transaction with another counterparty. Entering into an equal but opposite contract with the same counterparty eliminates the market and credit risks associated with the contract. Doing so with a different counterparty eliminates market risk but not credit and other risks associated with carrying two contracts. Alternatively, the counterparties can negotiate a termination agreement that settles the contract or agree to assign the contractual obligation to a third party.

development would be the creation of a swaps clearinghouse. A clearinghouse could provide benefits, such as reducing credit risk and increasing market access, but it could also increase systemic risk by concentrating credit risk in a single entity and thus might require federal oversight.

CFTC's swaps exemption does not bar a clearinghouse, but it does require that a proposal for such a facility be submitted to CFTC for review. As noted above, CFTC's swaps exemption includes a condition that requires each counterparty to consider the other's creditworthiness. Because of this requirement, swaps market participants may not be able to use a clearinghouse without jeopardizing their exempt status and becoming subject to the CEA's regulatory requirements. According to CFTC, the development of a swaps clearinghouse would not necessarily require CFTC to amend the exemption. Instead, CFTC could exempt a swaps clearinghouse from the CEA's provisions (except section 2(a)(1)(B)) on such conditions as it deemed appropriate. According to CFTC officials, the extent to which CFTC would need to impose conditions on a clearinghouse would depend on the facility's design, applicability of other regulatory regimes, and other factors.

Among other alternatives, CFTC could use its exemptive authority to accommodate a swaps clearinghouse or any other market development that is inconsistent with the conditions of the existing swaps exemption. In accommodating such a swaps market development, CFTC may need to include conditions in the exemption to ensure that the risks and other regulatory concerns of the development are appropriately addressed. Depending on the risks and concerns, such conditions may include reporting, recordkeeping, disclosure, or other regulatory requirements that are similar to the regulations that CFTC has imposed on the OTC derivatives under its oversight—trade options, dealer options,[60] and leverage contracts.[61]

[60]Dealer options are off-exchange commodity options that are confined to a limited class of offerors who were in the business of granting options on physical commodities and buying, selling, producing, or otherwise using that commodity as of May 1, 1978, and who satisfy the requirements of CFTC regulations. Dealer options are a retail product and are not currently being offered.

[61]Leverage contracts are long-term (10 years or longer) OTC contracts involving metals and foreign currencies and are not currently being offered.

CFTC's Use of Its Exemptive Authority to Impose Regulatory Conditions Could Prompt Legal Challenges and Raise Jurisdictional Questions

Imposing regulatory conditions on swaps participants might be an effective way for addressing potential risks to the market that could result from a swaps market development. However, such an approach could prompt legal challenges and raise jurisdictional questions. First, as long as the issue of whether swaps are futures is not definitively addressed, the possibility remains that a court could find swaps to be outside the jurisdiction of the CEA if CFTC tried to use its exemptive authority to impose affirmative requirements on swaps. Second, imposing affirmative requirements on swaps might suggest that swaps are futures and subject to regulation under the CEA, even if CFTC did not explicitly make that determination. Any suggestion that swaps are futures and subject to regulation under the CEA could have policy ramifications for the swaps market because of CFTC's exclusive jurisdiction over futures. Any such suggestion could also raise jurisdictional questions involving federal bank regulators and SEC because of their oversight or regulation of swaps participants or swaps. Tasked with considering new developments in the financial markets, including the increasing importance of the OTC derivatives market, the President's Working Group on Financial Markets provides one forum through which CFTC and other federal regulators could address such issues.

The Rationalization of Regulatory Differences Between the OTC Derivatives and Exchange-Traded Futures Markets Is an Unresolved Issue

The development of the swaps and exchange-traded futures markets has raised questions about the rationale for their regulatory differences—recognizing that each market may not raise the same risks and, thus, warrant the same regulations. Swaps and exchange-traded futures are similar in their characteristics and economic functions, but differ in, among other ways, their trading environment and regulations. As discussed above, CFTC exempted swaps and other OTC contracts from regulation under the CEA. In 1995, CFTC also granted the exchanges an exemption from certain regulations to enable them to compete more effectively against the less regulated OTC derivatives market. Notwithstanding the exemption, OTC derivatives and exchange-traded futures market regulations continue to differ substantially. The exchange exemption represents one approach to rationalizing regulations between the two markets but also illustrates some of the challenges in doing so.

Swaps and Exchange-Traded Futures Have Similarities and Differences, Including the Scope and Focus of Their Regulation

Swaps and exchange-traded futures are similar in their characteristics and economic functions but differ in other ways, including the scope and focus of their regulation. Swaps and exchange-traded futures have market values that are determined by the value of an underlying asset, reference rate, or index. They also are used for hedging financial risk and investing with the intent of profiting from price changes by some of the same general types of market participants, such as financial institutions, commercial firms, and governmental entities. Given their similar economic functions, OTC derivatives and exchange-traded futures can be used as substitutes for one another, but they are not perfect substitutes because of differences in their contract terms, transaction costs, regulations, and other factors. They also can be used to complement each other. Some market participants—primarily banks and other financial firms acting as dealers—use exchange-traded futures to hedge the risk related to their OTC derivatives positions. As a former CFTC chairman noted, the exchange-traded futures market has grown closer to the swaps market as it has expanded to remain competitive. The exchanges are offering more flexible option contracts, whose terms can be customized to meet an end-user's particular risk-management needs. Moreover, they are working on other proposals, such as collateral depositories, to address the needs of participants using swaps and other OTC derivatives.

Notwithstanding their similar characteristics and economic functions, differences between swaps and exchange-traded futures may result in different risks that lead to differences in the types and/or levels of oversight needed for each market. Swaps and exchange-traded futures differ in ways that are reflected in CFTC's swaps exemption. As discussed above, unlike exchange-traded futures, swaps are not traded on a multilateral execution facility, such as an exchange, or cleared through a multilateral clearing facility, such as a clearinghouse. Rather, swaps are entered into between two counterparties in consideration of each other's creditworthiness. Although plain vanilla swaps have become more homogeneous in terms such as their underlying reference rates or indexes and maturities, each contract continues to be privately negotiated.

Unlike exchange-traded futures, swaps and other OTC derivatives are not regulated under a single, market-oriented structure or subject to a contract approval process, because they are privately negotiated contracts. They are regulated only to the extent that the institutions using or dealing in them are regulated. As we noted in our May 1994 report, banks are major OTC derivatives dealers. They are overseen by federal bank regulators and subject to supervision and regulations—including minimum capital, reporting, and examination requirements. These regulations are designed to ensure the safety and soundness of banks but are not directly concerned with protecting those doing business with them.[62] Other major dealers include affiliates of securities and insurance firms that are subject

[62]We are currently reviewing OTC derivatives sales practices and will report our findings separately.

to limited or no federal oversight. Since our 1994 report, CFTC, federal bank regulators, and SEC have taken several steps to improve their oversight of the major OTC derivatives dealers, including affiliates of securities firms. Also, a group of derivatives dealers, in coordination with SEC and CFTC, has developed a voluntary oversight framework for the OTC derivatives activities of unregulated affiliates of securities and futures firms. We discuss these and other actions taken by federal regulators and derivatives market participants in the November 1996 update to our 1994 report on financial derivatives.

Traditionally, exchange-traded futures have been regulated as a market under a comprehensive regulatory structure, which is designed to protect customers and the market—including its efficiency, fairness, and financial integrity. This regulatory structure covers not only certain market participants but also the products and markets on which they trade. Unless exempted, futures must be traded on designated exchanges and through regulated intermediaries, subject to minimum capital, reporting, examination, and customer protection requirements. The CEA and CFTC specify certain self-regulatory duties—including providing for the prevention of manipulation, making reports and records on market activities, and enforcing exchange rules—that an exchange must perform to become and remain a designated exchange. The CEA also requires CFTC to review and approve products traded on a designated exchange.

CFTC's Exchange Exemption Is One Approach to Rationalizing OTC and Exchange-Traded Futures Market Regulations but Illustrates the Challenges in Doing So

In 1993, two futures exchanges separately requested that CFTC exempt from most of the CEA's regulatory requirements certain exchange-traded futures that are traded solely by institutional and other sophisticated market participants. The exchanges indicated that they needed regulatory relief to compete fairly with the less regulated OTC market. In response to the exchange requests, CFTC provided the exchanges with regulatory relief under an exemption issued in November 1995. CFTC, however, did not provide the exchanges with the broad regulatory relief they requested. CFTC based its position, in part, on comments it received on the exchange requests from various government agencies, members of Congress, and the public, as well as on the 1992 act's legislative history. In the latter, Congress cautioned CFTC to use its exemptive authority sparingly and not to prompt a wide-scale deregulation of markets falling under the act.

The exchange exemption is to be implemented under a 3-year pilot program.[63] It is intended to enable qualifying exchanges to list new contracts with greater ease and construct OTC-like trading procedures,

[63]The 3-year pilot program will begin when the first contract is traded under the exchange exemption.

permitting market participants to negotiate prices privately and execute trades off of the exchange floor. The exchange exemption limits access to the exempted futures market to specified participants, which are generally the same institutional and sophisticated participants that may use exempted swaps. In addition, the exemption is intended to streamline requirements for registering brokers and disclosing risks when opening new customer accounts. However, with the exception of these regulatory changes, all other CEA provisions and CFTC regulations would continue to apply to the exempted futures market. For example, the requirements related to recordkeeping and audit trails as well as transaction reporting would continue to apply.

According to CFTC, the exchange exemption would enable the exchanges to compete more effectively with the OTC derivatives market, while maintaining basic customer protection, financial integrity, and other protections needed for trading in an exchange environment. Furthermore, CFTC noted that the pilot program would provide it with an opportunity to (1) test the operation of the exemption, (2) determine the effect of exempted transactions on the integrity of the market as a whole, and (3) determine whether continued trading under the exemption would be in the public interest. To date, CFTC has not received any proposals under the exchange exemption.

In a joint statement released at the June 1996 Senate Agriculture hearing (discussed above), 10 futures exchanges noted that the exchange exemption does not provide a level playing field for exempted exchange-traded and OTC derivatives contracts. They noted that exempted exchange-traded contracts would continue to be subject to the bulk of CFTC regulations, even though such contracts, like exempted OTC derivatives, would not be traded by public customers. The exchanges also maintained that CFTC's exchange exemption is not consistent with the 1992 act's legislative history—noting that, among other things, Congress intended CFTC, in consideration of fair competition, to use its exemptive authority in a fair and even-handed manner to products and systems sponsored by exchanges and nonexchanges.

As mentioned earlier, Senators Lugar, Harkin, and Leahy as well as Congressman Ewing recently introduced bills to amend the CEA. Each bill includes a provision that would largely exempt from regulation under the act certain exchange-traded futures that are traded solely by institutional and sophisticated market participants. In a joint statement released at the February 11, 1997, hearing on reforming the CEA, 10 futures exchanges noted that the Senate bill "moves exchanges a long way toward achieving a regulatory balance with the OTC markets." They noted that the exempted market would rely on market discipline and self-regulation, with the exchanges having a business incentive to operate a fair, financially sound, and competitive market. At the same hearing, CFTC testified that, if enacted, the bill would likely cause a broad elimination of federal regulation of the exchange-traded futures market and create significant risks by doing so.

CFTC's exchange exemption represents one approach to rationalizing regulatory differences between the exchange-traded futures and swaps markets but illustrates some of the challenges in doing so. The exchange and swaps exemptions raised similar policy questions that CFTC approached from opposite viewpoints, in part because of the existence of a regulatory structure for one but not the other. For futures, the basic question was: "What is the appropriate regulation for futures traded on exchanges solely by institutional and other sophisticated market participants?" In this regard, CFTC's approach to exempting exchange-traded futures focused on determining which CEA requirements could be eliminated without compromising the public interest, as defined in the CEA. Under this approach, the exchanges were tasked, in part, with demonstrating which existing regulations were unnecessary. In comparison, the basic question for swaps was: "Are swaps appropriately regulated under the CEA?" In this regard, CFTC's approach to exempting swaps focused on determining whether CEA requirements needed to be imposed on the market.

Another related challenge in rationalizing regulations between the two markets arose from the similar nature of the participants.[64] As required under its exemptive authority, CFTC considered the nature of the market participants in exempting swaps. It limited the swaps exemption to participants it deemed sophisticated or financially able to bear the risks associated with these transactions. Likewise, it considered the exclusion of unsophisticated participants from the exempted exchange-traded futures market as the most important factor supporting its exchange exemption. However, CFTC noted that, unlike a dealer market, a centralized market composed solely of sophisticated market participants did not obviate the need to ensure market integrity, price dissemination, and adequate protections against fraud, manipulation, and other trading abuses. It further noted that CFTC regulations serve other vital functions,

[64]CFTC has characterized exchange-traded futures market participants as largely institutional, and a former CFTC commissioner stated that the majority of users of regulated, exchange-traded futures meet the eligibility requirements of the swaps exemption.

even where such markets include only sophisticated participants, in that the regulations substitute for individualized credit determinations and increase market access. The exchanges have disagreed with CFTC's conclusions. They have stated that their safeguards—including clearinghouse guarantees and price transparency—provide greater protections than available in the OTC market but, at the same time, prevent them from obtaining regulatory relief comparable to that which CFTC provided to the OTC market.

Conclusions

CFTC has used its exemptive authority to reduce or eliminate legal risk in the OTC derivatives market arising from the combination of the CEA's judicially crafted futures definition and exchange-trading requirement. Through its efforts, CFTC has enhanced the legal enforceability of most OTC derivatives contracts and, in doing so, has enabled the OTC derivatives market to continue to grow and develop. Nonetheless, several legal and regulatory issues involving the CEA remain unresolved. These include the legal uncertainty facing equity swaps, the CEA's lack of clear criteria for distinguishing unregulated forwards from regulated futures, the uncertainty surrounding the scope of the Treasury Amendment, and the extent to which CFTC should use its exemptive authority to provide greater regulatory relief to the futures exchanges. Ongoing congressional efforts to amend the CEA could provide specific solutions to these unresolved issues. Further, such efforts could provide a forum for addressing the broader policy question of what the appropriate regulation is for exchange-traded futures and OTC derivatives contracts, including their markets and market participants.

The appropriate regulation for the exchange-traded and OTC derivatives markets should flow from the need to protect the public interest in these markets. The CEA identifies the public interest in the futures market as the need to protect the market's price discovery and risk-shifting functions from market abuses, such as excessive speculation, manipulation, and fraud. However, articulating the public interest in this way may no longer provide a sufficient basis for regulating all aspects of the futures market, given market developments and regulatory changes. As discussed, the exchange-traded futures market is now dominated by financially based futures and institutional participants. Because of the greater liquidity of the underlying cash markets for financial products, the exchange-traded futures markets for these products may not serve the same price discovery function as exchange-traded futures based on agricultural and other physical commodities. Accordingly, they may not serve the price discovery function that Congress intended to protect when crafting the CEA. In addition, CFTC now has the authority to allow futures to be traded off-exchange and free from the comprehensive regulatory structure applicable to exchange-traded futures. Because of the way they would be traded and other factors, off-exchange futures may not raise the same risks or regulatory concerns that exchange-traded futures raise and for which regulation under the CEA was deemed necessary to protect the public interest. Nonetheless, off-exchange futures may raise other risks, such as systemic risk, or regulatory concerns that warrant federal regulation.

To address the broader policy question of the appropriate regulation for the exchange-traded futures and OTC derivatives markets, more fundamental questions concerning the goals of federal regulatory policy need to be answered. These questions include:

- What is the current public interest in the exchange-traded futures and OTC derivatives markets that needs to be protected?
- What type of regulations are needed, if any, and what is the most efficient and effective way to implement and enforce any needed regulations? To what extent are the answers to these questions affected by the nature of the market participants; trading environment; and products, including their function, type of underlying commodity, and degree of standardization?

These fundamental questions provide a framework for systematically determining the appropriate regulation for exchange-traded futures and OTC derivatives, including their markets and market participants. Moreover, answers to these questions would also provide a basis for considering an array of options for amending the CEA. These options include (1) expanding the act's jurisdiction to cover specified swaps and other OTC derivatives but tailoring their regulation to the circumstances under which they trade and other appropriate factors; (2) excluding swaps and other specified OTC derivatives from the act's jurisdiction and providing for their oversight, as appropriate, by other federal regulators; and (3) tailoring the level of regulation for exchange-traded futures to the nature of the market participants and/or other appropriate factors.

Swaps and other OTC derivatives involve institutions and activities in which federal bank regulators and SEC have traditionally had a supervisory or oversight role, while futures trading and futures market regulation have fallen under the CFTC's exclusive jurisdiction. As a result, any policy questions raised by the ongoing development of the OTC derivatives and exchange-traded futures markets cross traditional jurisdictional lines and involve not only CFTC but also federal bank regulators and SEC. The cooperative efforts of these agencies, working with the Department of the Treasury and the financial industry, will be required to address such questions. As discussed, the President's Working Group on Financial Markets provides one forum through which to coordinate interagency activities and address policy questions that cross jurisdictional lines.

As we concluded in our May 1994 OTC derivatives report, the U.S. financial regulatory structure has not kept pace with the dramatic and rapid changes in the domestic and global financial markets. We noted that one issue needing to be addressed is how the U.S. regulatory system should be restructured to better reflect the realities of today's rapidly evolving global financial markets. Our conclusion was based partly on the finding that the development of new types of financial derivatives and their use by a variety of once separate industries, such as banking, futures, insurance, and securities, have made it more difficult to regulate them effectively under the current U.S. regulatory structure. The potential legal and regulatory issues raised by the evolving OTC derivatives and exchange-traded futures markets under the CEA further illustrate such difficulty and reinforce the need to examine the existing U.S. regulatory structure. Ultimately, maintaining a globally competitive U.S. derivatives market will require balancing the goal of allowing the U.S. financial services industry to innovate and grow with the goal of protecting customers and the market, including its efficiency, fairness, and financial integrity.

Agency and Industry Comments and Our Evaluation

We requested comments on a draft of this report from the heads, or their designees, of CFTC, the Department of the Treasury, the Federal Reserve Board, the Office of the Comptroller of the Currency, and SEC. We also requested comments from three futures exchanges (the Chicago Board of Trade, Chicago Mercantile Exchange, and New York Mercantile Exchange), the New York Stock Exchange, and four industry associations (the Futures Industry Association, International Swaps and Derivatives Association, Managed Futures Association, and National Futures Association). CFTC, the Department of the Treasury, the Federal Reserve Board, and SEC provided us with written comments under a joint response as members of the President's Working Group on Financial Markets. We also obtained written comments from two futures exchanges (the Chicago Mercantile Exchange and Chicago Board of Trade) and the four industry associations. The written comments and our additional responses are contained in appendixes I through VII. We did not receive written comments from the Office of the Comptroller of the Currency, New York Mercantile Exchange, or New York Stock Exchange. In addition, officials from CFTC, the Department of the Treasury, the Federal Reserve Board, the Office of the Comptroller of the Currency, SEC, the International Swaps and Derivatives Association, and the Chicago Mercantile Exchange provided us with technical comments that were incorporated into the report as appropriate.

The President's Working Group on Financial Markets commented that it agreed with our conclusion that maintaining a globally competitive U.S. derivatives market requires properly balancing the need to allow the U.S. financial services industry to innovate and grow with the need to protect the financial integrity of our markets. The Working Group noted that it is effectively addressing intermarket financial coordination issues and that further discussion in that forum of issues we identify would be useful.

The Futures Industry Association commented that the draft did not adequately address the question of whether or to what extent additional regulation of the OTC derivatives markets is warranted, and to the extent warranted, whether the CEA is the appropriate vehicle for such regulation. Similarly, the International Swaps and Derivatives Association stated that there has been no demonstration that participants would benefit from subjecting swaps to any form of regulation under the CEA. Our overall objective was to provide Congress with information on the legal and regulatory issues involving the CEA, not to determine the appropriate level of regulation for the OTC derivatives market or the specific vehicle for any such regulation. We identified regulatory gaps in this market in our May 1994 report on OTC derivatives and recently issued a report that discusses the actions taken by federal regulators and the industry since that time. Nonetheless, the issues that we discuss lead to the broader policy question of what the appropriate regulation is for the OTC derivatives and exchange-traded futures markets. In our conclusions, we provide a framework for addressing this policy question and, in turn, related questions, such as whether the CEA is the appropriate vehicle for regulating swaps and other OTC derivatives.

In a related comment, the Futures Industry Association noted that our draft asserts that financial products serving a risk-shifting function should be subject to similar regulatory treatment, even though the CEA has recognized through its statutory exclusions that the regulation of such products may appropriately differ depending on their nature and underlying market. Correspondingly, the International Swaps and Derivatives Association commented that risk-shifting activities related to foreign exchange and other transactions were specifically excluded from the CEA pursuant to the Treasury Amendment, demonstrating that Congress did not intend for the CEA to govern all financial transactions involving the transfer of risk. We do not assert that risk-shifting contracts should be subject to similar regulation. Rather, we note that the CEA covers futures contracts, which have been defined in a way that reflects their risk-shifting function. As a result, OTC derivatives serving a similar risk-shifting function as futures may fall within the definition of a futures contract and be subject to the CEA. We agree that the CEA's statutory exclusions demonstrate that Congress did not intend for the CEA to govern all risk-shifting contracts. However, these exclusions are not broad enough to provide similar treatment for all OTC derivatives, many of which, including swaps, did not exist when the exclusions were created. CFTC has exempted most swaps and other OTC derivatives from virtually all the CEA's requirements to provide them with greater legal certainty, but a question remains about whether swaps are futures and subject to the CEA. As we discuss, the possibility that swaps are futures continues to be a source of legal risk for equity swaps.

In another related comment, the Chicago Board of Trade, Futures Industry Association, and Managed Futures Association noted that the CEA provides CFTC with the authority and flexibility to address issues raised by the evolving OTC derivatives and futures markets. We agree that the CEA, with its exemptive authority provision, does not prevent CFTC from addressing regulatory concerns raised by the OTC derivatives market, as needed. In our report, we state that CFTC could use its exemptive authority to address regulatory concerns raised by a swaps market development that is inconsistent with the conditions of the existing swaps exemption. However, we note that this approach could suggest that swaps are futures and introduce jurisdictional questions. We also note that the President's Working Group on Financial Markets provides one forum through which to address such questions.

The Chicago Board of Trade commented that, contrary to the impression created in the draft, jurisdictional ambiguities in the act (the definition of a futures contract and the Treasury Amendment) are not solely responsible for the disparate regulatory treatment of exchange and OTC markets. Instead, it cites the manner in which CFTC has chosen to use its authority as leading to this disparity. According to the exchange, CFTC did not use its exemptive authority in a way that is consistent with the 1992 act's legislative history—that is, it did not use its authority in a fair and even-handed manner to products and systems sponsored by exchanges and nonexchanges. In a related comment, the Futures Industry Association noted that it agrees with the draft report's implicit assumption that CFTC's exchange exemption could be broadened. However, it stated that the exchanges must provide CFTC with greater specificity as to the nature of the products, trading mechanisms, and clearing structure that would be subject to exemptive relief. We agree with the Chicago Board of Trade that the act's jurisdictional ambiguities are not solely responsible for the regulatory differences between the OTC derivatives and futures markets. Our report states that CFTC provided less regulatory relief under its exchange exemption than it did under its OTC derivatives exemptions. We also agree with the Futures Industry Association that greater specificity could aid CFTC in the use of its exemptive authority to provide additional regulatory relief to the exchanges. However, in granting the exchange exemption, CFTC followed the congressional admonition to use its exemptive authority sparingly and not to cause a wide-scale deregulation of markets falling under the act. Given the different ways of interpreting the 1992 act's legislative history, we note in our conclusions that one of the unresolved issues involving the CEA is the extent to which CFTC should use its exemptive authority to provide greater regulatory relief to the futures exchanges.

We are sending copies of this report to the Chairperson of CFTC, the Comptroller of the Currency, the Chairman of the Federal Reserve Board, the Chairman of SEC, the Secretary of the Treasury, and other interested parties. We will also make copies available to others upon request.

Please contact me at (202) 512-8678 or Cecile O. Trop, Assistant Director, at (312) 220-7600 if you or your staff have any questions. Major contributors to this report are listed in appendix VIII.

Jean Gleason Stromberg

Jean Gleason Stromberg
Director, Financial Institutions
and Markets Issues

Contents

Abbreviations

CEA	Commodity Exchange Act
CFTC	Commodity Futures Trading Commission
OTC	over-the-counter
SEC	Securities and Exchange Commission

Comments From the President's Working Group on Financial Markets

See p. 40.

September 20, 1996

Mr. James L. Bothwell
Director, Financial Institutions and
Market Issues
General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

As the members of the President's Working Group on Financial Markets, we submit this joint response on the draft report entitled The Commodity Exchange Act: Contributes to Legal and Regulatory Uncertainties in the Derivatives Markets.

As you know, the Working Group was reactivated in 1994, in part to ensure that concerns about the public policy implications of the growth of derivative markets are properly addressed.

The Working Group believes that the United States continues to have the safest, most liquid, and competitive financial markets in the world and the safest and soundest banking system. Nonetheless, we agree with the GAO that maintaining a globally competitive U.S. derivatives market requires properly balancing the need to allow the U.S. financial services industry to innovate and grow with the need to protect the financial integrity of our markets. These issues are broad and complex and involve questions concerning the goals of regulatory policies and the best means of achieving those goals.

The staff of the agencies which we head have or will provide technical comments to your staff on the draft report. Regarding broader concerns, we believe we are effectively addressing intermarket financial coordination issues through the Working Group and that further discussion in that forum of the issues you identify would be useful. We are committed to taking whatever additional steps are appropriate to ensure that the regulatory system keeps up with the evolution of the financial markets.

Sincerely,

Robert Rubin
Secretary of the Treasury

Alan Greenspan
Chairman
Board of Governors of the Federal
Reserve System

Arthur Levitt
Chairman
Securities and Exchange
Commission

Brooksley Born
Chairperson
Commodity Futures Trading Commission

Comments From the Chicago Board of Trade

Chicago Board of Trade

Thomas R. Donovan
President and
Chief Executive Officer

September 3, 1996

James L. Bothwell
Director, Financial Institutions
and Markets Issues
General Government Division
United States General Accounting Office
Washington, D. C. 20548

Re: Draft Report "The Commodity Exchange Act: Contributes to Legal and Regulatory Uncertainties in the Derivatives Markets," GAO Job Code 233442

Dear Mr. Bothwell:

Thank you for the opportunity to review and comment on the GAO's draft report on the Commodity Exchange Act (the "Act" or the "CEA"). As we have come to expect from your office, this complicated issue was handled in a cogent, sophisticated manner. In particular, we commend GAO for its insightful analysis of the extent to which the regulatory structure has not kept pace with innovation in the financial markets and of the lack of regulatory parity for functionally equivalent exchange-traded and over-the-counter derivative products.

There is much in the draft report with which we agree. However, in the interest of efficiency, we will focus our comments on the areas where we see things differently.

See pp. 41-42.

We share the view expressed in the draft report that there is a lack of parity in the regulatory treatment of the OTC derivatives market and organized futures exchanges. We do not agree with the draft's analysis of the source of that disparity and the way to correct it.

See pp. 41-42.

Congress did not direct the CFTC to exempt the OTC derivatives market or any part of it from the Act and did not mandate the form of those exemptions. Section 4(c)(1) and (5) of the Act says that the Commission "may" grant exemptions from its requirements. Contrary to the impression created by the draft report, jurisdictional ambiguities in the Act (in the definition of a futures contract and in the Treasury Amendment) are not solely responsible for the disparate regulatory treatment of exchanges and OTC markets. In 1992, Congress sought to address these ambiguities by giving the CFTC exemptive authority in Section 4(c) of the Act. The manner in which the Commission has chosen to exercise its authority under the Act has led to this disparity.

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The 1992 amendments to the Act and their legislative history contradict the view that Congress left the Commission no choice but to regulate the exchanges more heavily than the OTC markets. Congress specified that CFTC exemptions must comply with the same legal standard: any exemption must be "consistent with the public interest." CEA §4(c)(1). Furthermore, Congress specified what the CFTC's public interest test should include -- "the prevention of fraud and preservation of financial integrity of markets, as well as the promotion of responsible economic or financial innovation and fair competition." H.R. Rep. No. 978, 102d Cong., 2d Sess. 78 (1992). At no time did Congress indicate that those public interest factors or the exemptions on which they depend were to be skewed in favor of either OTC or exchange-traded transactions.

To the contrary, recognizing that both types of derivatives markets would vie for exemptive relief, Congress provided that the Commission must "promote fair competition." CEA §4(c). Both §4(c) and the 1992 amendment to CEA §15 expressly impose a fair competition mandate on the Commission's exercise of its new exemptive powers. The Act requires the Commission to impose the same "public interest" standard in assessing exemptive relief for OTC and exchange markets in order to promote "fair competition."

See p. 35.

The legislative history underscores that conclusion. The 1992 Conference Committee Report states that "[t]he Conferees intend that the Commission, in considering fair competition, will implement this provision <u>in a fair and even-handed manner to products and systems sponsored by exchanges and non-exchanges alike.</u>" H.R. Rep. No. 978, 102d Cong., 2d Sess. 78 (1992) (emphasis added). The report continues:

> "The conferees expect that, in this process, the Commission will apply consistent standards based on the underlying facts and circumstances of the transactions and markets being considered and may make distinctions between exchanges and other markets, taking into account the particular facts and circumstances involved, consistent with the public interest and the purposes of the Act, where such distinctions are not arbitrary and capricious.

Later in the same report, the Committee directed that "Commission exemptive action also should reflect <u>the least anticompetitive means</u> of exempting persons or transactions from the provisions of the Act." <u>Id</u>. at 81 (emphasis added).

In effect, Congress said, "If you decide to grant these exemptions, do so fairly." But the problem is that the solution devised by Congress has not been implemented.

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That solution is for the Commission to make exemption decisions "in a fair and even-handed manner" by treating similar products similarly. In other words, the Commission should not be predisposed to grant exemptions for products it has not regulated and should not be predisposed to deny exemptions for products it has regulated. Instead, the Commission deliberately built a disparate regulatory structure by making disparate assumptions on six issues.

See p. 41.

First, in reviewing the Exchange's request for exemptive relief, the Commission claimed to be bound by a Congressional directive to use its exemptive authority "sparingly" and not to cause "wide-scale deregulation of markets falling within the ambit of the Act." 59 Fed. Reg. at 54142, quoting H.R. Rep. No. 978, 102d Cong., 2d Sess. 81 (1992). It did not rely on that admonition when it granted OTC swaps a wholesale exemption. "Markets" include OTC markets as well as exchange markets. The Commission has misapplied its instructions from Congress by treating exchange requests for relief more harshly than the requests of their OTC competitors.

See p. 34.

Second, in reviewing the Exchange's request for exemptive relief, the Commission observed:

> "[T]he fact that a centralized market is composed solely of institutional or 'sophisticated' participants does not obviate the need to ensure market integrity, price dissemination, and adequate protections against fraud, manipulation, and other trading abuses by continued Commission regulation and oversight." 59 Fed. Reg. at 54142.

See pp. 36-37.

Yet, in granting OTC exemptions, the Commission has consistently relied on the size and sophistication of market participants as a reason to relax regulatory measures relating to financial integrity and customer protection. Id. (OTC derivatives transactions may be "unsuitable for regulation" due solely to the "nature of the parties" to those transactions.) See also 58 Fed. Reg. 21286, 21292 (April 20, 1993); 58 Fed. Reg. at 5592.

See p. 36.

Nevertheless, the CFTC has recognized that the very nature of exchange trading provides safeguards which are not present in OTC markets, including price transparency, a clearing guarantee, and a system of self-regulation. 52 Fed. Reg. 47022 (Dec. 11, 1987). Ironically, some of these very safeguards disqualify exchange markets from obtaining relief under Part 35. In effect, the safer the market, the narrower the exemption.

See pp. 36-37.

Third, in the context of OTC markets, the Commission has accepted the notion that the costs of federal regulation would discourage growth and innovation. In the

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See p. 37.

context of exchange markets, the Commission has taken the Orwellian view that federal regulation confers a competitive advantage on U.S. exchanges. The Commission went so far as to claim partial credit for the growth of exchanges since the enactment of the CEA "because of the regulatory scheme under which they operate and the resulting public confidence in the fairness of the markets." 59 Fed. Reg. at 54142. The truth is that unregulated OTC markets have grown at a faster rate than their exchange competitors, and that, excepting the CFTC view, regulation is universally regarded as a competitive disadvantage.

See p. 36.

Fourth, the Commission justifies the disparate treatment of exchange-traded and OTC products on historical grounds. Exchanges have been regulated for seventy years, while OTC products have never been regulated. This argument would have some merit if many OTC products were not virtually indistinguishable from futures contracts. As it is, this argument resurrects the circular reasoning, rejected by the Commission elsewhere, that a contract is a futures contract if it is traded on an exchange.[1] In fact, the Commission reserved antifraud authority over the swaps market, which necessarily presumes that those products are futures contracts subject to the CEA. The Commission has also relied on historical reasons for denying any exemptive relief for contracts which it has already approved (that is, existing exchange-traded products), while OTC swaps were granted a retroactive exemption. This is simply antithetical to the pro-innovation policy which inspired Section 4(c) of the Act.

See pp. 37-38.

Fifth, the Commission assumed that the price discovery function of an exchange distinguishes it from its OTC competitors and that the public interest would be served better by regulating rather than exempting exchange markets. This assumption is wrong for two reasons. First, liquidity rather than regulation determines whether a product will be accepted as a pricing referent. If fair pricing is an issue, then trading on an open, competitive exchange would seem to be less susceptible to questionable pricing than trading where the dealer alone sets the price.

[1] CFTC Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30694 (July 21, 1989); CFTC v. CoPetro Marketing Group, Inc., 680 F. 2d 573 (9th Cir. 1987) (Trading on a CFTC-approved exchange does not make a contract a futures contract, but does make a futures contract legal).

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Second, exchange trading is not the exclusive forum for price discovery. Some OTC markets provide a price discovery function,[2] while some exchange-traded contracts are not liquid enough to provide price discovery benefits.

See p. 41.

Sixth, the Commission has experience in regulating non-exchange traded products. Its Part 31 Regulations govern leverage transactions and Part 32 Regulations govern dealer options. The Commission is capable of creating regulatory structures for non-exchange traded products and is not restricted by the Act from doing so.

See p. 36.

Unfortunately, the Commission's first attempt at exempting products it has traditionally regulated failed to overcome the regulatory law of inertia: a product that is regulated tends to remain regulated. The forces of logic and fairness were no match for the institutional presumption to the contrary, and the half-hearted Part 36 was the result.

See p. 32.

As described in the draft report, the regulatory structure created for swaps under Part 35 of the Commission's Regulations is significantly simpler and less onerous than the regulatory structure created for equivalent exchange traded products under Part 36. The attached chart graphically identifies the principal differences, which undeniably limit the exchanges' ability to compete with their OTC counterparts.

See p. 8.

As the draft report observes, the products involved in exchange trading and the OTC derivatives markets serve the same risk-shifting function. In our view, the Commission's attempts to articulate a basis for imposing different regulatory requirements on functionally equivalent products constitute agency sophistry rather than sound public policy.

See p. 42.

The Commodity Exchange Act imposes a very broad mandate on the CFTC, which it has chosen to interpret in a very narrow and, most would admit, tortured way. Functional regulation does not require significant changes to the Commodity Exchange Act. It does require the CFTC to do the job Congress assigned to it. The Commission already has the authority and the experience to regulate non-exchange

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[2] CRS Report for Congress: Derivative Financial Markets 30 (Congressional Research Service, October 29, 1993)(many OTC derivatives, particularly "plain vanilla" swaps, now trade "in a large and liquid marketplace" where "swap traders could adjust their positions very quickly." Through this liquidity, price discovery and hedging benefits "are now available to users of the derivatives markets." Id. at 17. See also "How Low Can They Go?" THE ECONOMIST (October 30, 1993) at 94 (One "indicator of firms' view of interest rates is the spread between interest rate swaps and the government bonds over which they are priced.").

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markets and products. What it lacked in reviewing exchange requests for Part 35-type treatment was the will to innovate and to treat functionally equivalent products in a "fair and even-handed manner" despite Congress' clear expectations. We do not quarrel with the eligibility of the OTC markets for the relief they obtained in Part 35. We strongly believe that exchanges should have comparable and equivalent relief, both for existing and new products.

We urge you to incorporate these points into your final report.

Again, we commend GAO for a careful analysis of an important public policy issue.

Respectfully submitted,

Thomas R. Donovan

Thomas R. Donovan

Comments From the Chicago Mercantile Exchange

CHICAGO MERCANTILE EXCHANGE

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August 30, 1996

Mr. James L. Bothwell
Director, Financial Institutions and Markets Issues
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Washington, D.C. 20548

Dear Mr. Bothwell:

Thank you for the opportunity to review a draft of the GAO's proposed Report to Congress respecting the impact of the Commodity Exchange Act on legal and regulatory uncertainties in derivatives markets. We believe that the GAO has come to a proper understanding of many of the disparities between organized exchanges and the over-the-counter markets. We were particularly impressed with the draft report's insights on how the over-the-counter market is rapidly converging with organized exchange markets in terms of customers served, products offered, standardization, and reduction of contra-party risk. While we have a few technical suggestions, which are appended to this letter, our real concern is that the GAO's implicit conclusion appears to be that over-the-counter derivatives should be exempted from regulation under the Commodity Exchange Act while identical products with an identical customer base trading in an inherently safer environment ought to continue to be subjected to the extensive regulation that has come to characterize CFTC regulated exchanges.

See comment 1.

At page 41 of the GAO's report, the GAO includes a lucid description of how the CFTC approached the exemption process from opposite viewpoints when dealing with over-the-counter markets and exchange markets. The GAO established that the CFTC granted far ranging exemptions to the over-the-counter market by asking whether there were any grounds to believe that the regulatory scheme imposed on futures markets needed to be applied to the over-the-counter market. At the same time, when exchanges asked for comparable exemptions for their proposed professional trading markets, the CFTC demanded that the exchanges prove that existing regulations were unnecessary to protect the same customers, trading the same products, in a far safer environment. This shifting of the presumption and burden of proof resulted in wildly disparate treatment of exchanges and over-the-counter markets.

Now on p. 36.

The GAO report itself applies the same reasoning. The conclusion, beginning at page 42, focuses on whether the CEA's principle of functional regulation really works where OTC and exchange markets are trading functionally equivalent products under disparate regulatory regimes. In particular, the GAO asks, "what is the appropriate regulation for OTC derivatives and whether the CEA can keep pace with ongoing market changes." The GAO focuses, then, on distinguishing

See comment 1.

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between regulations appropriate for OTC derivatives and exchange traded products. We strongly believe that this is not the appropriate dichotomy and that drawing the line at that point will strongly influence policy toward an incorrect allocation of regulatory burdens.

In effect the GAO drew a vertical line separating OTC markets from exchange markets. We believe it is far more appropriate to draw a horizontal line dividing professional markets from retail markets. The question that should be highlighted is whether derivative transactions between sophisticated investors need to be subjected to the same regulatory regime as derivative transactions in which unsophisticated individuals are involved. If the GAO had asked this question rather than focusing on the OTC versus exchange traded derivatives issue, it would be far more likely to result in a regulatory regime that meets the balance which you identify as important at page 43:

Now on p. 39.

> "Maintaining a globally competitive U.S. derivatives market requires properly balancing the need to allow the U.S. financial services industry to innovate and grow with the need to protect the safety and soundness of the nation's financial system."

In order to achieve that balance, we believe it is essential to clearly identify the purpose for which a regulation is imposed and then to impose that regulation on all functionally equivalent transactions. Therefore, if it is appropriate to exempt derivative transactions among sophisticated parties that are conducted in an over-the-counter market -- a market that is acknowledged by all to be riskier than an organized exchange -- it is even more appropriate to exempt the same transactions when conducted on an organized exchange, subject to clearing and other risk management procedures.

See p. 38.

The GAO report, while excellent in all other respects, is trapped by the same philosophy that drove the CFTC to exempt the over-the-counter markets while over-regulating exchanges. In sum, we strongly urge that the GAO give Congress the opportunity to make a regulatory distinction between high level commercial transactions among sophisticated parties, which all of us recognize should not be subject to the regulatory minutia imposed by the CFTC, and retail transactions involving derivative instruments, which need government oversight. The failure of the GAO Report to come to grips with this issue, which is the focus of academic and practical concern, detracts from its otherwise excellent analysis.

See comment 1.

Sincerely,

William J Brodsky

WJB:rap

The following are GAO's comments on the Chicago Mercantile Exchange's August 30, 1996, letter.

GAO Comments

1. The Chicago Mercantile Exchange commented that our use of the way that derivatives are traded (off-exchange versus on-exchange) as the basis for distinguishing OTC derivatives from futures for regulatory purposes is not an appropriate dichotomy. Rather, the exchange commented that the nature of the market participant (professional versus retail) is a better basis to use in determining the appropriate level of regulation needed for derivatives markets. We revised our report, and the referenced text no longer appears. In our conclusions, we provide a framework for determining the appropriate regulation for the OTC derivatives and exchange-traded futures markets, focusing on the current public interest in these markets that needs to be protected. As part of that framework, we note that the nature of the market participant, trading environment, and other factors should be considered in determining the regulations that are needed to protect the public interest.

Comments From the Futures Industry Association

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September 18, 1996

James L. Bothwell
Director, Financial Institutions
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United States General Accounting Office
Washington, D.C. 20548

Re: GAO Draft Report Entitled: "The Commodity Exchange Act Contributes to Legal and Regulatory Uncertainties in the Derivatives Markets"

The Futures Industry Association (FIA) welcomes the opportunity to comment on the General Accounting Office's (GAO) draft report entitled "The Commodity Exchange Act Contributes to Legal and Regulatory Uncertainties in the Derivatives Markets" dated September 1996 (Draft Report). Members of the FIA and their affiliates represent the major professional participants in both the exchange-traded futures and over-the counter (OTC) derivatives markets and have a significant interest in developments affecting each of these markets.

The FIA commends the GAO for its efforts to provide a comprehensive summary of the history of the Commodity Exchange Act (CEA) regulation and areas of legal uncertainty within this complex and esoteric legal regime.[1] While the FIA is disappointed that the GAO did not consult the FIA and other trade associations and industry participants in the research phase of this project, we hope that the clarifications and observations summarized below will provide an additional perspective on some of these issues and assist the GAO in finalizing its report.

See p. 7.

See p. 7.

1 We would like to make two technical observations with respect to the Draft Report's description of the CEA's regulatory structure. First, we assume that the reference in the second sentence of footnote 9 in the Draft Report to "Futures on options" is intended to be a reference to "Options on securities". Second, although the Seventh Circuit Court of Appeals held (in the GNMA decision that led to the codification of the Shad-Johnson Accord) that CEA Section 2(a)(1)(A)(i) confers exclusive jurisdiction to the CFTC over all commodity options, including options on physical commodities, the conclusion that the CFTC's jurisdiction over physical commodity options is exclusive remains subject to some uncertainty.

For convenience, our comments are organized roughly in the order in which the related topic is addressed in the Draft Report.

Parallels between OTC Derivative Products and Exchange-traded Products

The FIA concurs in the view that exchange-traded futures and OTC derivatives each perform a risk shifting function and can be used to accomplish similar economic objectives, although the potential for individualized tailoring of OTC derivatives enables users to accomplish objectives that cannot be accomplished by standardized contracts. The FIA also agrees that OTC derivatives and exchange-traded contracts both complement and compete with each other.

See comment 1.

Nonetheless, in our view, the regulatory analogy drawn in the Draft Report between these two categories of products based on their shared risk shifting characteristics oversimplifies the relevant issues. The Draft Report does not adequately address the policy implications arising from the important distinctions that exist between the trading of fungible products, on an agency basis, on a centralized exchange and clearinghouse, on the one hand, and the execution of individually negotiated, non-fungible products, on a principal to principal basis, in a decentralized market of independent dealers, on the other hand.

See pp. 41-42.

While recognizing that these distinctions have practical and regulatory significance, the FIA believes that professional participation in the exchange-traded futures markets should not be subjected to excessive or competitively inhibiting regulation. Much can be done to ameliorate regulatory burdens in this area. In this regard, we agree with the Draft Report's implicit assumption that the exemptive relief extended to the exchanges by the CFTC under Part 36 of its regulations could be broadened. To facilitate this result, however, we believe the exchanges must provide greater specificity as to the nature of the products, trading mechanisms and clearing structure that would be the subject of exemptive relief than was provided in the context of the Part 36 rulemaking. Greater specificity would facilitate more informed decisionmaking as to the scope of regulation that would be appropriate to preserve market and financial integrity.

Functional Regulation Under the CEA

See comment 2.

The notion that financial products that serve similar risk shifting functions should be subject to similar regulatory treatment is a predicate of much of the discussion in the Draft Report. The CEA is cited in the Draft Report as embracing this principle.

See pp. 40-41.

From its inception, however, the CEA has recognized that the regulatory treatment of financial products may appropriately differ depending on the nature of, and the underlying markets for, such products -- even though the products share risk-shifting characteristics. For example, the regulatory treatment of forward contracts, which perform a risk shifting function, differs entirely from that of exchange-traded futures contracts. Subsequent amendments to the CEA, including the Treasury Amendment and the Shad-Johnson Accord (CEA § 2(a)(1)(B)), have also resulted in differential regulatory treatment of similar risk-shifting financial products.

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The CEA also draws commodity-based distinctions (as do CFTC regulations). For example, the Treasury Amendment carves out from CEA jurisdiction, among other transactions, certain transactions in foreign currencies, government securities, mortgage products and other financial instruments. Similarly, the treatment of securities under CEA § 2(a)(1)(B) differs from that of other commodities under the CEA.

The U.S. commodities laws are not the only regulatory scheme under which financial products serving similar economic functions are subject to differing regulation treatment. For example, the regulatory treatment of publicly traded bonds, privately placed debt, bank loans and certificates of deposit differ significantly even though all serve a comparable capital raising function.

See p. 38.

The FIA believes that the same policy considerations that justify exclusion of forward contracts from regulation under the CEA are generally applicable to OTC derivatives. The forward markets are decentralized markets in which individualized transactions are privately negotiated among generally sophisticated counterparties with no centralized trading or clearing mechanisms. Accordingly, the regulatory framework applicable to exchange-traded futures contracts appears to us to be a less appropriate analogy for OTC derivatives than that of forward contracts.

Definition of Futures Contract

See comment 3.

The Draft Report accurately identifies three elements that are necessary to conclude that a contract is a futures contract. However, we are not aware of any judicial or CFTC precedent concluding that the three elements identified in the Draft Report are alone sufficient to define a contract as a futures contract.

See comment 4.

While it is true that exchange trading is what makes a futures contract legal and not what defines a futures contract, the question of what types of financial products are appropriately regulated under the CEA as futures contracts can be usefully considered against the background of Congress' statement of intent as set forth in Section 3 of the CEA. CEA Section 3 specifically identifies transactions in contracts for future delivery as "commonly conducted on a board of trade" as the type of activity requiring regulation under the CEA. FIA believes that this statement of Congressional intent reflects a sensitivity to the regulatory significance of distinctions between exchange trading and private negotiation of contracts that is equally relevant today.

Weaknesses in the Description and Analysis of OTC Derivatives

There are several aspects of the descriptions of and discussion regarding OTC derivatives that could benefit from further clarification.

See comment 5.

As a general matter, the Draft Report overstates the current level of convergence between futures and OTC derivatives markets. For example, the Draft Report occasionally fails adequately to distinguish between standardization of the documentation of a financial product and standardization of the economic terms of a financial product. It is only the latter that makes

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such products fungible. The term "plain vanilla" can be misleading in this context. Similarly, the Draft Report fails to appreciate, and address the policy implications of, the distinction between a collateral management function, on the one hand, and a clearing system that mutualizes credit risk, on the other hand.

In addition, the FIA disagrees fundamentally with the Draft Report's observation that the participation of dealers in the OTC derivatives markets implies that such markets are "centralized". There are scores of professional intermediaries participating in the OTC derivatives markets. The participation of professional intermediaries in these markets does not in FIA's view make the OTC derivatives markets centralized.

See comment 6.

Forwards and Futures

With respect to the distinction between futures and forward contracts, the Draft Report sometimes fails adequately to distinguish between the nature of the obligation to make delivery and what constitutes delivery. While one Ninth Circuit decision has raised some question regarding the latter issue, it is the first issue that has been the subject of extensive discussion.

See comment 7.

The FIA recognizes that legitimate concerns exist with respect to the prudence of the "hedging" strategies employed in connection with "hedge-to-arrive" contracts. However, the financial losses that have been experienced by parties to these transactions do not appear to arise from the character of the delivery obligations or the lack of a bona fide delivery obligation. Even with a binding delivery obligation, the hedge-to-arrive contracts that appear to have resulted in significant losses would present the same financial risks to the counterparties involved.

See comment 8.

With respect to the regulatory distinction between futures contracts and forward contracts, the FIA believes that the CFTC's Brent Interpretation made significant progress in reducing the uncertainty caused by precedents such as the Transnor decision which employed a test that required an after-the-fact analysis of the subjective intent of each party to a transaction. We believe the agency's interpretation, by focusing on the objective (and more readily verifiable) test of the legal obligations created, represents the correct view of the law on this subject.

See comment 7.

Treasury Amendment

We were confused as to how the Draft Report reached the conclusion that the Treasury Amendment is limited (or was intended to be limited) to "interbank" trading. The legislative history of the Treasury Amendment includes clear references to a broad range of market participants, including sophisticated institutions, traders and individual investors. We are unaware of any reference to a limitation on the scope of the Treasury Amendment to "interbank" trading either in the statute or its legislative history.

While there is a broad range of views on the scope of the Treasury Amendment, we are not aware of any federal regulatory agency, including the CFTC, that has adopted such a restrictive view of the scope of the Treasury Amendment.

See comment 9.

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Conclusion

See p. 40.

The FIA generally agrees with many of the points cited in the Draft Report's conclusion. However, in our opinion, the body of the Draft Report does not adequately analyze the threshold question whether or the extent to which additional regulation of the OTC derivatives markets is warranted, and to the extent warranted, whether the CEA is the appropriate vehicle for such regulation.

See p. 41.

To the extent that the OTC derivatives markets may be evolving to more closely resemble futures markets (a conclusion which we believe to be exaggerated), the Draft Report's conclusion that the CEA is inadequate to respond to this development is merely conclusory and is not supported by analysis. The Draft Report correctly observes that the CEA's regulatory scheme contemplates exchange trading. However, the FIA believes that, except in the case of § 2(a)(1)(B), the CEA includes broad rulemaking and exemptive authority that provides the CFTC with the authority and flexibility to address an evolving marketplace. If the GAO disagrees with this view, the Draft Report should include an analysis that would support the conclusion.

The FIA appreciates this opportunity to provide its comments on the Draft Report to the GAO. Please do not hesitate to contact the undersigned if you should have any questions with regard to the foregoing.

Very truly yours,

John M. Damgard
President

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The following are GAO's comments on the Futures Industry Association's September 18, 1996, letter.

GAO Comments

1. The association commented that the draft focused on the similar economic function served by OTC derivatives and exchange-traded futures but did not adequately address the policy implications arising from the important distinctions that exist between the two types of products. We focus on the similar risk-shifting function served by OTC derivatives and exchange-traded futures because the CEA covers futures, which have been defined in a way that reflects their risk-shifting function. As we discuss in our conclusions, Congress and federal regulators will need to consider the similarities and differences between the OTC derivatives and exchange-traded futures markets in addressing the broader policy question concerning the appropriate regulation for these markets. We agree that important distinctions exist between OTC derivatives and exchange-traded futures that have policy implications, and we amplified our discussion of these distinctions.

2. The association commented that our draft cited the CEA as embracing the principle of functional regulation. We eliminated the term functional regulation because of the confusion over its meaning, but our message has not changed. That is, the CEA covers futures, which CFTC and the courts have defined in a way that reflects their risk-shifting function. As a result, contracts serving a similar risk-shifting function as futures may fall within the definition of a futures contract and be subject to the CEA.

3. The association commented that our draft report listed the necessary elements of a futures contract without mentioning that such elements are not necessarily sufficient to define a futures contract. We modified the report accordingly.

4. The association commented that section 3 of the CEA specifically identifies transactions in contracts for future delivery "commonly conducted on a board of trade" as the type of activity requiring regulation under the CEA. It further noted that this statement reflects a sensitivity to the regulatory significance of distinctions between exchange trading and private negotiation of contracts that is equally relevant today. We agree that the exchange-trading requirement is central to the CEA's regulatory structure and recognize that differences exist between OTC derivatives and exchange-traded futures that may warrant differences in their regulation. In that regard, our conclusions provide a framework for determining the

appropriate regulation for the OTC derivatives and exchange-traded futures markets, focusing on the public interest in these markets that needs to be protected. As part of that framework, we note that the nature of the market participant, trading environment, and other factors should be considered in determining the regulations needed to protect the public interest.

5. The association noted that the draft report overstated the current level of convergence between the OTC derivatives and futures market. We revised the report to amplify our discussion of the similarities and differences between the OTC derivatives and futures markets.

6. The association disagreed with the draft report's observation that participation of dealers in the OTC derivatives markets implies that such markets are centralized. We did not intend to imply that the swaps market is centralized and have revised the draft accordingly. We recognize that swaps continue to be privately negotiated between counterparties and are neither traded on a centralized facility nor cleared through a clearinghouse. We note that swaps have followed a similar evolutionary path as exchange-traded futures. However, we recognize that the extent to which the swaps market, or some part thereof, will continue to evolve in the same way as the exchange-traded futures market is unknown.

7. The association commented that, with respect to the distinction between futures and forwards, our draft report sometimes fails to distinguish between the nature of the obligation to make delivery and what constitutes delivery. Our discussion of the disagreement between CFTC and the federal district court on where to draw the line regarding the delivery requirement for Brent Oil contracts was meant to illustrate this difference. We also note in our conclusions that one of the unresolved issues is the CEA's lack of criteria for distinguishing unregulated forwards from regulated futures.

8. The association commented that the losses associated with hedge-to-arrive contracts do not appear to arise from the character of the delivery obligations. We note that unusual factors, such as high grain prices and poor weather conditions, have resulted in financial problems for parties to these contracts. However, we also note that the legal risk facing some hedge-to-arrive contracts due to the possibility that they could be illegal futures or trade options has complicated matters. This legal risk may persist, even in the absence of the factors contributing to financial risk.

9. The association commented that the Treasury Amendment's scope was broader than the restricted view presented in the draft report. Our discussion of the Treasury Amendment was not intended to provide an interpretation of the amendment's scope but rather to describe the legal confusion created by how others have interpreted its scope. We modified the report accordingly.

Comments From the International Swaps and Derivatives Association

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September 10, 1996

James L. Bothwell
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The Commodity Exchange Act: Contributes to Legal and Regulatory Uncertainties in the Derivatives Markets

The International Swaps and Derivatives Association, Inc. ("ISDA") is pleased to submit this comment letter in response to the draft of the above-referenced report (the "Report") by the United States General Accounting Office (the "GAO") sent to us on August 2, 1996.

As you are aware, ISDA is an international organization whose membership comprises 291 of the world's largest commercial, merchant and investment banks, corporations, governmental entities and other institutions. ISDA's members represent a broad cross section of the institutions that act as dealers and end-users of privately negotiated derivatives transactions both in the United States and worldwide. A recent list of ISDA's members is attached hereto as Annex A. Many of the issues addressed in the Report are of great importance to ISDA and its members.

I. Introduction

In addition to ISDA's members, many corporations, financial institutions and government entities in the United States rely on swaps and other privately negotiated derivatives transactions (collectively, "swaps" or "swap transactions") to manage the risks associated with their financial and commercial activities. Such activities give rise to a host of risks, many of which could not be hedged or managed in an efficient manner, if at all, without the use of such transactions. Therefore, the availability of swaps at low cost and within a strong legal framework in the United States is of vital interest to all ISDA members and other institutions that rely on swaps. Any legal

ISDA
INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

uncertainty presents a source of risk to individual institutions and to the financial markets as a whole.

For these reasons, one of ISDA's main goals since its inception has been to promote legal certainty for swaps. ISDA has been particularly concerned with the legal uncertainties relating to the status of swaps under the Commodity Exchange Act (the "CEA"), and has, in other forums, set forth its view that legislative measures should be taken to ensure that swaps are not subject to inadvertent characterization as futures contracts. ISDA, therefore, largely agrees with the Report's analysis of the legal uncertainties that currently exist under the CEA and with the GAO's view that corrective action is necessary. Such analysis offers constructive information which will be helpful to the Senate Committee on Agriculture, Nutrition, and Forestry in its attempt to introduce legislation to amend the CEA to address many of these issues. ISDA believes that one of the alternatives presented by the GAO to address these legal uncertainties, passing legislation that makes it clear that swaps are not subject to regulation under the CEA, deserves serious consideration.

See comment 1.

Due to the customized nature of swap transactions, and the fact that they result from bilateral negotiations among identifiable counterparties that may expose one party to the credit risk of the other, swaps differ considerably from the fungible futures contracts historically governed by the CEA. ISDA believes that the Report largely ignores this reality by painting a misleading picture of similarities between futures and swaps and failing to properly address the important differences that exist, which differences justify the disparate regulatory treatment of these two distinct types of financial transactions. We are also concerned about the factual inaccuracies contained in the Report, as well as the Report's characterization of the legislative, regulatory and judicial histories relating to the CEA, which, although depicted as fact in the Report, are open to interpretations different from those contained in the Report. ISDA believes that the GAO's suggestion that swaps are becoming more similar to futures contracts is incorrect, and that any inference that swaps should be subject to regulation under the CEA, albeit pursuant to a modified framework left unspecified by the GAO, is not supported by the facts.

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II. Swaps Differ From Futures Contracts in Important Respects which Justify the Disparate Regulatory Treatment

The Report unsuccessfully attempts to equate swaps and futures by asserting that (i) swaps and futures have similar economic functions, (ii) swaps are evolving into "centralized, off-exchange market transactions", (iii) swap participants are increasingly using practices similar to those used in the futures markets to reduce credit and other risks and (iv) swaps and futures "share the same general market participants".

See comment 2.

Although both types of transactions can have a similar economic purpose, the transfer of risk, the same can be said for practically every type of financial transaction (as well as certain commercial activities), including those involving securities, loans, guarantees and various types of insurance contracts. Attempting to implement a regulatory framework that would subject every form of financial or commercial activity that involves the transfer of risk to regulation under the CEA would clearly be inappropriate. The fact that substantial risk-shifting activities relating to foreign exchange and other transactions were specifically excluded from the CEA pursuant to the Treasury Amendment demonstrates that Congress did not intend for the CEA to govern all financial transactions involving the transfer of risk.

See pp. 40-41.

See comment 3.

The Report's second assertion is simply untrue; swaps are not centralized market transactions. The GAO seems to ignore its own definition of a centralized trading market set forth in the Report, "a market where participants are able to execute transactions simultaneously and bind both parties by accepting offers that are made by one participant but open to all market participants". Such definition does not accurately describe swap activity, which takes place across the globe on an individually negotiated basis. There is no centralized order flow as there is in centralized markets. In fact, it is not at all clear that swap activities constitute a market in the true sense of the word, as evidenced by the absence of secondary market trading. While quotes on certain types of swap transactions are visible on trading screens, such quotes are merely "indicative" and do not represent firm, binding offers. Many other types of decentralized financial and commercial activities involve the dissemination of price information by a multitude of participants.

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The GAO attempts to support its assertion by pointing out that almost all trades go through dealers, and that swap activities have become more liquid and transparent. However, the fact that trades are executed through dealers does not indicate the existence of a centralized market. Insurance is sold only through licensed brokers; cars are primarily sold through dealers -- neither of these activities would be considered centralized. It appears that the GAO confuses its incorrect perception that swap activities are concentrated in a handful of large dealers with centralization. Such a perception would be mistaken. There is a large and growing number of institutions across the globe prepared to deal in swaps. As of August 30, 1996, ISDA's primary members comprised 166 dealer institutions that each conduct a significant volume of swap activities, as compared to 46 institutions in 1986.

See comment 3.

The Report also attempts to portray swaps as a centralized market by incorrectly asserting that swap participants are actively discussing the possibility of establishing a swaps clearinghouse. We are not aware of any meaningful discussions pertaining to the establishment of such a clearinghouse. Although certain vendors have approached swap participants about the possibility of setting up a collateral depository, which would facilitate and coordinate the administrative functions necessary for collateralized transactions, such a depository is quite different from a clearinghouse and is merely a way of facilitating collateral management. It does not eliminate credit risk (or concentrate it in one entity) and does not evidence a centralized market. Similarly, just because swap participants negotiate a range of credit mitigation techniques (which, contrary to the Report's assertions, differ from those used in the futures market in important respects) does not mean that swaps and futures are functional equivalents.

See comment 4.

The fact remains that swaps are quite different from futures contracts in many important respects: (i) they are transactions between two specific counterparties, (ii) they are individually negotiated transactions where the terms are customized to the particular needs of the counterparties and (iii) the identity and credit quality of the counterparty is of primary importance. This is starkly different from the standardized, fungible, anonymously executed futures contracts which are guaranteed by the clearinghouse of the exchange on which they trade. Although swaps are often executed pursuant to master agreements

See p. 33.

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derived from a standard template, the important commercial terms, those relating to payment obligations and credit concerns, are not standardized. The timing, frequency and amount of the swap payments, as well as the applicable credit terms, are individually tailored according to the needs and nature of particular counterparties. Such master agreements, which are used to establish the terms that will govern the ongoing bilateral relationship between the counterparties, dramatically reduce transaction costs and legal uncertainties. These differences are responsible for the fact that 70% of corporate end-user's turn to swaps to meet their risk management needs, as compared to 17% which turn to the futures market, disproving the Report's assertion that swaps and futures "share the same general market participants".

See comment 5.

III. Swaps Should Not be Subject to Regulation Under the CEA

As the Report itself recognizes, the characteristics of swaps would make it unworkable and inappropriate to subject them to the exchange-trading requirement of the CEA. There has been no demonstration that participants would benefit from subjecting swaps to any form of regulation under the CEA, even pursuant to a modified regulatory approach, as suggested by the Report.

See p. 40.

The Report notes that the principal purposes of the CEA are to prevent price manipulation and other detrimental practices and to "protect the public interest in, among other things, the market's efficiency, fairness and financial integrity". Given the nature of the transactions, swap rates are not subject to the same type of market congestion and manipulation concerns that are sometimes raised in connection with standardized contracts executed by anonymous market participants on an exchange, particularly since swap activities are not centralized. In addition, because credit risk is a consideration in these types of transactions, participants have strong incentives to transact only with counterparties they deem to be creditworthy, fair and honest. Market forces and concern for reputation provide incentives for swap participants to act responsibly.

See p. 6.

It is also important to note that participants choose to enter into swaps with the expectation of transacting in a decentralized environment not subject to functional regulation. The tremendous growth in the number and types of transactions indicates that concerns about efficiency, fairness and financial integrity are not an issue for swap participants. The few incidents where participants believed they were treated unfairly by their counterparties have demonstrated both the ability of swap participants amply to protect their rights through existing legal remedies, and the fact that such incidents represent bilateral disputes between two swap participants with no implications for third parties. The Report offers no evidence that additional regulatory protection is needed or desired by swap participants, nor any evidence that, even if such additional protection were needed, the CEA, which was not designed to regulate such off-exchange transactions but to prohibit them entirely, would be the appropriate avenue to effect such protection.

See comment 6.

See comment 7.

The swap activities of the institutions that are thought to be subject to systemic risks and/or are supported by public insurance are closely supervised by various regulatory agencies. Finally, ISDA is unaware of any regulatory regime in any jurisdiction that directly and functionally regulates all privately negotiated swap transactions.

IV. Portions of the Report are Misleading in Certain Respects

ISDA believes that certain portions of the Report contain factual inaccuracies and may mislead the reader. For example, the Report incorrectly asserts that the CEA, as amended in 1974, embraced the principle of functional regulation. In fact, we believe it would be more accurate to acknowledge that the 1974 legislation was a step toward institutional regulation, since it established regulation by the Commodity Futures Trading Commission (the "CFTC") of what had been unregulated trading on futures exchanges, and concurrently excluded from CFTC regulation foreign exchange and other transactions taking place outside of futures exchanges by promulgating the Treasury Amendment. Additionally, although the Treasury Amendment is subject to varying interpretations, as evidenced by the differences of opinion among various federal circuit courts of appeal, the Report asserts uncategorically, and without direct evidence, that the legislative history surrounding the Treasury Amendment indicates that it was intended to apply solely to the interbank market. This is a narrower view than that taken by any other regulatory agency, including the CFTC.

See comment 8.

See comment 9.

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The Report also gives incomplete coverage to the relevant judicial precedents and CFTC administrative proceedings. For example, the Report sets forth a list that it claims contains the "necessary elements" of a futures contract identified by the courts and the CFTC, and sets forth certain "additional elements" that "facilitate futures trading on exchanges but do not define what makes a futures contract". This analysis incorrectly summarizes the relevant precedents and implies that such necessary elements are also "sufficient" elements; the CFTC and others have determined that certain of these "additional elements" are in fact "necessary elements" and that such list does not represent all essential elements. In addition, the definition of "offset" set forth in the Report as one of these necessary elements is broader than has been defined in regulatory and judicial contexts.

See comment 10.

See comment 11.

Conclusion

In conclusion, ISDA believes that privately negotiated swaps do not raise the same public interest concerns as futures and do not warrant regulation under the CEA. The GAO raised similar questions about the need for additional regulation of swap activities in its May 1994 report entitled "Financial Derivatives: Actions Needed to Protect the Financial System". After consideration of this report, various legislators and regulatory agencies concluded that an additional regulatory regime for swap transactions was not necessary. Nothing has changed since that time to warrant a change in that conclusion. In fact, since 1994, financial institutions have improved substantially the measurement and management of the risks arising from trading activities, including derivatives. In addition, various regulatory agencies have improved their understanding of swap activity. The economic realities of swap activities, the nature of swap participants, and the existing regulatory regimes and market forces which impact upon and govern these activities and participants are likely to lead to continuing improvements in the future.

See comment 7.

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ISDA hopes that the GAO will modify the Report to take account of the views expressed herein. If the GAO or its staff have any questions regarding ISDA's comments or related issues, they should feel free to contact the

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undersigned or any members of the ISDA Board of Directors listed in Annex B attached hereto. Again, ISDA appreciates the opportunity to provide its comments on the Report.

Yours sincerely,

Gay H. Evans

Gay H. Evans
Chairman
International Swaps and Derivatives Association, Inc.

The following are GAO's comments on the International Swaps and Derivatives Association's September 10, 1996, letter.

GAO Comments

1. The association commented that the draft painted a misleading picture of the similarities between exchange-traded futures and swaps by focusing on their risk-shifting function and failed to properly address the important differences between them that justify their disparate regulatory treatment. We focus on the similar risk-shifting function served by OTC derivatives and exchange-traded futures because the CEA covers futures, which have been defined in a way that reflects their risk-shifting function. As we discuss in our conclusions, Congress and federal regulators will need to consider the similarities and differences between the OTC derivatives and exchange-traded futures markets in addressing the broader policy question concerning the appropriate regulation for these markets. We agree that important distinctions exist between OTC derivatives and exchange-traded futures that have policy implications, and we amplified our discussion of these distinctions.

2. The association commented that, although OTC derivatives and exchange-traded futures serve a similar risk-shifting function, many other financial transactions, including those involving securities, loans, guarantees, and various types of insurance contracts, can serve such a function. It further noted that attempting to implement a regulatory framework that would subject every form of financial or commercial activity that involves the transfer of risk to regulation under the CEA would clearly be inappropriate. We agree that it would be inappropriate to subject all instruments that can serve a risk-shifting function to the CEA. However, as CFTC and others have recognized, swaps and other OTC derivatives resemble futures not only in terms of their economic function but also in terms of their design. Given the market's continued growth and development, questions remain about the extent to which additional regulation of the OTC derivatives market is needed. In our conclusions, we provide a framework for determining the appropriate regulation for the OTC derivatives and exchange-traded futures markets, focusing on the public interest in these markets that needs to be protected.

3. The association commented that the draft report's assertion that swaps are a centralized market is not true. We did not intend to imply that the swaps market is currently centralized and have revised the draft accordingly. We recognize that swaps continue to be privately negotiated between counterparties and are neither traded on a centralized facility nor

cleared through a clearinghouse. We note that swaps have followed a similar evolutionary path as exchange-traded futures. However, we recognize that the extent to which the swaps market, or some part thereof, will continue to evolve in the same way as the exchange-traded futures market is unknown.

4. The association commented that the draft report portrayed swaps as a centralized market by incorrectly asserting that swaps participants are actively discussing the possibility of establishing a swaps clearinghouse. We discuss the potential for a swaps clearinghouse to illustrate an example of a development that could trigger a greater federal interest in the market. It was not intended to suggest that the swaps market has evolved into a centralized market, and we revised the draft accordingly.

5. The association noted that more corporations use swaps than exchange-traded futures to meet their risk-management needs, disproving the draft report's assertion that swaps and exchange-traded futures share the same general market participants. Our point was that swaps and exchange-traded futures are used by many of the same general types of market participants, not that swaps and exchange-traded futures are used by all of the same market participants. We revised the report to clarify this point. We still note that some of the same firms, namely banks and other financial firms acting as dealers, use both swaps and exchange-traded futures because of the complementary relationship of the contracts.

6. The association commented that few incidents exist where swaps participants believed that they were treated unfairly by their counterparties, which demonstrated both the ability of swaps participants to protect their rights and the fact that such incidents represent bilateral disputes with no implications for third parties. It added that the draft report offers no evidence that additional regulatory protection is needed or desired by swaps participants. We are currently reviewing OTC derivatives sales practices and will report our findings separately.

7. The association commented that the swaps activities of institutions that are thought to be subject to systemic risk and/or are supported by public insurance are closely supervised by various regulatory agencies. As we discussed in our May 1994 report on OTC derivatives, regulatory gaps existed in the OTC derivatives market that could heighten the potential for systemic risk. We have issued a report that updates our 1994 report and discusses actions taken by federal regulators and the industry since that time.

8. The association disagreed with the draft report's assertion that the CEA, as amended in 1974, embraced the principle of functional regulation. While we eliminated the term functional regulation because of the confusion over its meaning, our message has not changed. That is, the CEA covers futures, which CFTC and the courts have defined in a way that reflects their risk-shifting function. As a result, contracts serving a similar risk-shifting function as futures may fall within the definition of a futures contract and be subject to the CEA.

9. The association commented that our draft report asserts "uncategorically" and without direct evidence that the legislative history surrounding the Treasury Amendment indicates that it was intended to apply solely to the interbank market. Our discussion of the Treasury Amendment was not intended to provide an interpretation of the amendment's scope but rather to describe the legal confusion created by how others have interpreted its scope. We revised the report accordingly.

10. The association noted that our draft report listed the necessary elements of a futures contract without mentioning that such elements are not necessarily sufficient to define a futures contract. We modified the report accordingly.

11. The association commented that our definition of offset is broader than has been defined in regulatory and judicial contexts. We amended the offset definition to make it consistent with CFTC's definition and discussed the way that OTC derivatives are terminated in a later section of the report.

Comments From the Managed Futures Association

MANAGED FUTURES ASSOCIATION

October 15, 1996

James L. Bothwell
Director, Financial Institutions
and Markets Issues
United States General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Bothwell:

The Managed Futures Association is pleased to provide its comments on the GAO's recent report entitled *The Commodity Exchange Act Contributes to Legal and Regulatory Uncertainties in the Derivatives Markets.*

The MFA, a not-for-profit national trade association with over 600 members, represents the managed futures industry. The objective of the MFA is to enhance the image and understanding of the industry, to further constructive dialogue with regulators in pursuit of regulatory reform, and to improve communication with, and training of, the Association's members through effective conferences and communication programs. MFA is governed by an elected board of directors and has offices in Washington, D.C. and California. MFA membership is composed primarily of commodity pool operators and commodity trading advisors who are responsible for the discretionary management of the vast majority of the estimated $20 billion currently invested in managed futures products, including commodity pools and managed futures accounts.

MFA's members are active participants in derivative markets, both exchange traded and over the counter. Accordingly, MFA has a significant interest in the work of the GAO in these areas.

See comment 1.

MFA commends the GAO for an exhaustive and thorough examination of the current derivative marketplace. However, MFA does not share some the findings of GAO (e.g., limitation of the Treasury Amendment carve-out to the interbank market, definition of a "futures contract", and failure to recognize the continued non-centralized nature of the swaps market).

See p. 41.

MFA disagrees with the underlying premise of the Report concerning the efficacy of the Commodity Exchange Act (CFTC) and the Commodity Futures Trading Commission (CFTC) as they relate to the economic activities under review.

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The history of the CEA and CFTC has been one of innovation and flexibility. The 1974 amendments to the CEA (with exclusive jurisdiction and the creation of the CFTC) made the development and growth of financial futures and other derivatives possible. The economic benefits of such financial innovations were foreign to most other regulators, yet the CFTC consistently and prudently nurtured their growth. Congress enhanced the CFTC's capacity to further innovation, while still maintaining public protection, by granting comprehensive exemptive authority to the CFTC in the FTPA of 1992.

To date, the CFTC has exercised this authority cautiously. It retains plenary authority to provide legal certainty as appropriate and necessary as these markets evolve.

See p. 41.

The current CEA coupled with the unique and rich experience of the CFTC in overseeing risk-shifting derivative markets, both on-exchange and off-exchange, serves as a model statute which furthers the goals of both public protection and innovation.

Without getting bogged down in the semantics of functional vs. institutional regulation, MFA feels the CFTC has the unique experience and authority to craft appropriate regulatory structures (or decline to do so) for exchange or OTC derivatives, taking into account the nature of the participants (i.e., recognition of the two-tiered marketplace), the nature of the marketplace, centralized or not, among other factors.

See p. 41.

If you have any questions, please contact me.

Sincerely,

John G. Gaine
Director, Government Relations

cc: Cecile Trop

The following are GAO's comments on the Managed Futures Association's October 15, 1996, letter.

GAO Comments

1. The association commented that it does not share some of our findings regarding the limitation of the Treasury Amendment's carve-out of the interbank market, definition of a futures contract, and failure to recognize the continued noncentralized nature of the swaps market. We revised the report to clarify that we were not providing an interpretation of the Treasury Amendment's scope, but rather were describing the legal confusion created by how others have interpreted its scope. We modified the report to clarify that no definitive list exists of all the elements of a futures contract. We also amplified our discussion of the differences between the OTC derivatives and exchange-traded futures markets.

Comments From the National Futures Association

NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

ROBERT K. WILMOUTH
PRESIDENT

September 10, 1996

Mr. James L. Bothwell
Director, Financial Institutions
and Markets Issues
United States General Accounting Office
441 G Street, N.W.
Washington, D. C. 20548

Dear Mr. Bothwell:

National Futures Association appreciates the opportunity to comment on the GAO's recent report entitled *The Commodity Exchange Act Contributes to Legal and Regulatory Uncertainties in the Derivatives Markets.* NFA commends the GAO for its concise summation of the recent evolution of the OTC derivatives market and the conflicting case law which has arisen under the Treasury Amendment. The report clearly frames many of the complex issues which need to be addressed. Though the report does not propose specific solutions to those issues, it nonetheless performs the important function of placing the issues in their historical context and viewing them against the backdrop of the continuing evolution of the market place.

See comment 1.

The report raises the question of whether the regulation of OTC derivatives markets under the CEA, in effect, places a round peg in a square hole. The report notes that although the Commission has used the exemptive authority which Congress granted it in 1992, OTC products have evolved into a more standardized and centralized market, creating new uncertainties concerning the legality of these products. In our view, however, the report minimizes the inherent tension between the equally important goals of limiting legal uncertainty while maximizing regulatory flexibility.

See comment 1.

Cieariy, uncertainties concerning the enforceability of certain OTC contracts may stifle innovation. To the extent, however, that legal certainty is achieved by engrafting a static regulatory regime on a constantly evolving market, we merely substitute one means of stifling innovation for another. As a general matter, legal certainty requires regulatory specificity; specific regulations can become outmoded quickly; and outmoded regulations can be every bit as stifling as legal uncertainty. Thus, whether OTC derivatives are regulated under the CEA or a new piece of legislation, the dilemma remains the same – regulations must balance the needs for legal certainty for today's market and regulatory flexibility for tomorrow's. The key to that successful balancing rests with the agency to which Congress assigns that responsibility.

Congress recognized that in 1992 when it authorized the CFTC to exempt any contract from virtually all of the CEA provisions. As the report points out, the CFTC promptly used that authority to reduce the legal uncertainty for certain OTC derivatives.

NFA

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Mr. James L. Bothwell

September 10, 1996

See comment 2.

Later, the Commission granted more limited exceptions for exchange traded products which would be available only to more sophisticated market users. No one, including the CFTC, would suggest, however, that the Commission's work in this area is now completed. The swaps exemptions must be periodically revisited to make sure that the conditions set by the Commission for the exemption continue to make sense. At the same time, the exemptions granted to exchange traded products must also be reexamined. Not one exchange has thus far come forward with a proposal based on the Commission's Part 36 rules. If no exchanges have taken advantage of this opportunity, one questions whether there is an "opportunity" there at all and whether the Commission's rules truly promote the sort of level competition between exchange and OTC products that Congress clearly desired. In short, whether dealing with OTC products or exchange traded ones, the Commission must continue to recognize that different types of customers may need different types of protections and must review its requirements accordingly.

See comment 1.

The observation that more needs to be done, however, is little more than a recognition that the entire process of balancing the need for legal certainty with the need for regulatory flexibility is an ongoing one, whether performed under the CEA or any other legislation. Though the process is a difficult one, no one has made the case that the required balancing would be any easier under a different regulatory construct. Though the primary responsibility for balancing competing regulatory needs rests with the Commission, ultimate responsibility rests with Congress, and we would urge Congress to continue its close oversight of the Commission's activities to ensure that the Commission has exercised its exemptive authority as Congress intended.

See comment 3.

With respect to the Treasury Amendment, it is inconceivable to us that Congress ever did intend, intends now or ever will intend that futures contracts in foreign currencies can be mass marketed to the retail public without any of the protections afforded under the CEA. Whatever Congress may consider the ultimate boundaries of the Treasury Amendment, this basic point should be made as clearly as possible as soon as possible.

We appreciate having the opportunity to comment on the important issues raised in the GAO's report. Please do not hesitate to contact me if you have any questions.

Sincerely,

Robert K. Wilmouth

RKW:ckm(ltr-dr\gao.rkw)

The following are GAO's comments on the National Futures Association's September 10, 1996, letter.

GAO Comments

1. The association commented that the draft report minimized the inherent tension between the equally important goals of limiting legal certainty while maximizing regulatory flexibility. We agree that tradeoffs exist in addressing the legal and regulatory issues raised by the ongoing development of the OTC derivatives market under the CEA. Such tradeoffs raise difficult and often competing policy concerns that can lead to more fundamental questions concerning the goals of federal regulatory policy. In our conclusions, we provide a framework for determining the appropriate regulation for the OTC derivatives and exchange-traded futures markets, focusing on the public interest in the markets that needs to be protected.

2. The association noted that the swaps exemption must be periodically revisited to make sure that the conditions set by CFTC for the exemption continue to make sense. It also noted that CFTC must also reexamine the exemption granted to exchange-traded products. We agree that one alternative is to have CFTC revisit the exemptions, as needed, to address regulatory concerns raised by market changes and to ensure regulations do not impede market innovation and competition. However, we note that using such an approach for exempted swaps could suggest swaps are futures and introduce jurisdictional questions. Moreover, in our conclusions, we note that a remaining unresolved issue is the extent to which CFTC should use its exemptive authority to provide greater regulatory relief to the futures exchanges.

3. The association commented that, with respect to the Treasury Amendment, it is inconceivable that Congress intended for futures contracts in foreign currencies to be mass marketed to the retail public without any of the protections afforded under the CEA. As we discuss, confusion exists as to the scope of the Treasury Amendment, and we note in our conclusions that such confusion remains an unresolved issue under the CEA.

Major Contributors to This Report

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