exchanges are choosing to contract with new or existing clearing organizations for this aspect of traditional exchange activity. From what the Commission heard at the public hearing on the proposed framework, this trend is expected to continue and accelerate. Accordingly, this proposal represents a first step toward providing clearing organizations with the flexibility they will need to adapt to this new environment.

Nevertheless, I am sympathetic to the concerns of domestic clearing organizations regarding competition, jurisdiction and scope. Specifically, the final rule's treatment of securities clearinghouses, banks, bank affiliates, and foreign clearinghouses with regard to the requirements of Part 39 would appear to subject futures clearinghouses to a significant competitive disadvantage. The Commission's final rules justify this approach with little more than the observation that it is consistent with the ''unanimous recommendations of the President's Working Group.'' [1] Much more needs to be done so that one segment of the industry is not disproportionately affected and unfairly hamstrung by these regulations. Therefore, while I support the final rules to the extent they represent the Commission's willingness to meet the evolving marketplace with innovative approaches, I do so with the caveat that Part 39 will clearly need the Commission's full attention in order to ensure that the Commission is not picking winners and losers. At a minimum, since these reforms follow so closely the recommendations of the President's Working Group, I hope that the members of the PWG will respond swiftly to today's action by making parallel changes to their own regulatory schemes implementing the PWG's recommendations.

Date: November 20, 2000.

Thomas J. Erickson,

Commissioner.

[FR Doc. 00–30269 Filed 12–12–00; 8:45 am]

BILLING CODE 6351–01–P

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 35

RIN 3038–AB58

Exemption for Bilateral Transactions

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rules.

SUMMARY: The Commodity Futures Trading Commission (Commission or CFTC) is adopting final rules to clarify the operation of the current swaps exemption. In addition, in a companion notice of final rulemaking published in this edition of the **Federal Register**, the Commission is adopting rules that provide for the clearing of transactions under the revised exemption. The Commission, in other companion releases, also is adopting a new regulatory framework to apply to multilateral transaction execution facilities and to market intermediaries. This new framework establishes a number of new market categories, including a category of exempt multilateral transaction execution facility. Nothing in these releases, however, affects the continued vitality of the Commission's exemption for swaps transactions in effect before December 13, 2000, or any of its other existing exemptions, policy statements or interpretations.

EFFECTIVE DATE: February 12, 2001.

FOR FURTHER INFORMATION CONTACT: Paul M. Architzel, Chief Counsel, or Nancy E. Yanofsky, Assistant Chief Counsel, Division of Economic Analysis, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581. Telephone: (202) 418–5260. E-mail: *PArchitzel@cftc.gov* or *NYanofsky@cftc.gov*.

SUPPLEMENTARY INFORMATION:

I. The Proposed Rules

On June 22, 2000, the Commission published proposed amendments to its part 35 swaps exemption to expand and to clarify its operation, including the availability of clearing for these transactions.[1] These amendments were proposed in order to provide greater legal certainty to the over-the-counter (OTC) markets and to reduce systemic risk. The President's Working Group on Financial Markets (PWG) [2] and the chairmen of the Commission's Congressional oversight committees encouraged the Commission in this undertaking.

The Commission proposed the amendments to part 35 in light of the changes that have occurred in the OTC markets since the Commission adopted its Swaps Policy Statement in 1989, and its subsequent part 35 swaps exemption in 1993. In the intervening years, the OTC derivatives markets have experienced dramatic and sustained growth. During this period, OTC financial derivatives have developed into global markets having outstanding contracts with a total notional value of over $90 trillion.[3] OTC derivatives have transformed finance, increasing the range of financial products available for managing risk.

The Commission proposed making several changes to part 35. First, the Commission proposed deleting specific reference to ''swaps'' within the exemption itself. Instead, the rule would refer to a ''contract, agreement or transaction'' that meets the requisite exemptive conditions. Moreover, as suggested by the PWG Report, the Commission proposed to delete the requirement that exempt transactions not be fungible or standardized and to make clear that insofar as such exempt transactions may be cleared, creditworthiness of the counterparty is not a condition of the exemption. PWG Report at 17. In addition, the Commission proposed, through an exemption from the private right of action provision of section 22 of the Act, that transactions entered into in reliance on the part 35 swaps exemption would not be subject to a claim for rescission solely due to a violation of the exemption's requirements. See *id.* at 18.

In proposing the rules, the Commission affirmed the continuing vitality of the exemptive relief that it had previously granted to transactions in the OTC market, including the part 35 exemption, the Policy Statement Concerning Swap Transactions (54 FR 30694 (July 21, 1989)) (Swaps Policy Statement), the Statutory Interpretation Concerning Forward Transactions (55 FR 39188 (Sept. 25, 1990)) (Energy Interpretation), and the Exemption for Certain Contracts Involving Energy Products (58 FR 21286 (April 20, 1993)) (Energy Exemption). Moreover, in recognition of its continuing vitality and to assist the public in locating it, the Commission proposed publishing the Swaps Policy Statement as Appendix A to part 35.

II. Comments Received

The Commission received 31 comment letters on the proposed rulemaking.[4] The commenters included

[1] *See* Final Rules for a New Regulatory Framework for Clearing Organizations, p.12.

[1] 65 FR 39033 (June 22, 2000).

[2] Recognizing the importance of the OTC derivatives markets, the chairmen of the Senate and House Agriculture Committees requested that the PWG conduct a study of OTC derivatives markets. After studying the existing regulatory framework of OTC derivatives, recent innovations, and the potential for future developments, the PWG on November 9, 1999, reported to Congress its recommendations. See Over-the-Counter Derivatives Markets and the Commodity Exchange Act, Report of the President's Working Group on Financial Markets (PWG Report). The PWG Report focused on promoting innovation, competition, efficiency, and transparency in OTC derivatives markets and in reducing systemic risk.

[3] See Our Estimates of Global Size Market (visited Oct. 10, 2000), *http://www.swapsmonitor.com.*

[4] In addition to these 31, a significant number of letters commenting on aspects of the regulatory framework in companion notices were also submitted to the Commission. In this and three companion Notices of Final Rulemaking which are being published in this edition of the **Federal Register**, comment letters (CLs) are referenced by file number, letter number and page. Comments filed in response to the notice of proposed

nine trade associations,[5] three future exchanges,[6] two brokerage firms,[7] a coalition of commercial and investment banks,[8] four law firms,[9] four representatives of the energy services community,[10] an agricultural firm [11] and others.[12]

The majority of commenters strongly supported the Commission's proposed amendments and expressed the view that the amendments, among other things, would increase legal certainty for the OTC market. Two commenters took the opposite view, expressing jurisdictional concerns. The commenters also raised a number of technical issues concerning the operation of the exemption, the definition of ''eligible participant'' and other matters. The comments are addressed in the final rules section below.

rulemaking on multilateral transaction execution facilities, parts 36–38, are contained in file No. 21, on the notice of proposed rulemaking on intermediaries in file No. 22, on the notice of proposed rulemaking on clearing organizations in file No. 23 and on the notice of proposed rulemaking on the part 35 exemption in file No. 24. These letters are available through the Commission's internet web site, http://www.cftc.gov.

[5] The associations that filed comment letters are the Managed Funds Association, the International Swaps and Derivatives Association, Inc., the National Grain and Feed Association, the Futures Industry Association, the Commodity Floor Brokers & Traders Association, the Silver Users Association, the Weather Risk Management Association, the Association for Investment Management and Research, Advocacy Advisory Committee, Derivatives Subcommittee, and the Securities Industry Association, OTC Derivatives Products Committee.

[6] The futures exchanges that filed comment letters are the Chicago Board of Trade, the New York Mercantile Exchange and the Chicago Mercantile Exchange.

[7] The brokerage firms that filed comment letters are Merrill Lynch & Co. Inc. and J.P. Morgan Securities Inc.

[8] The coalition of commercial and investment banks (the Coalition) consists of the following financial institutions: The Chase Manhattan Bank, Citigroup Inc., Credit Suisse First Boston Inc., Goldman Sachs & Co., Merrill Lynch & Co., Inc. and Morgan Stanley Dean Witter & Co.

[9] The law firms that filed comment letters are Covington & Burling, McDermott, Will & Emery, on behalf of Virginia Electric & Power Company, Vinson and Elkins, and Gardner, Carter and Douglas.

[10] The representatives of the energy services community that filed comment letters are Williams Energy Marketing and Trading Company, the California Power Exchange, Oxy Energy Services, Inc. and Petrocosm Corporation.

[11] The agricultural firm that filed a comment letter is Cargill.

[12] The others filing comment letters are the National Futures Association, the Financial Markets Lawyers Group, the Federal Reserve Bank of Chicago, the U.S. Department of the Treasury, the Regulatory Studies Program of the Mercatus Center, Reuters Group PLC, and The EBS Partnership.

III. The Final Rules

A. The Exemption

Except for certain technical changes, the Commission is adopting the proposed rules expanding and clarifying the operation of the swaps exemption as final rules. As noted above, the majority of commenters strongly supported the amendments, expressing the view that they will increase legal certainty for the OTC market and reduce systemic risk. See, *e.g.*, CL 24–6; CL 24–8; CL 24–25; CL 24–29; CL 24–30; CL 24–31; CL 24–34; CL 24–36. The International Swaps and Derivatives Association (ISDA) views the proposed amendments as necessary to ensuring that new and evolving risk management tools will enjoy legal certainty comparable to that which has been available to transactions covered by the Commission's swaps exemption since 1993. CL 24–8 at 2. See also CL 24–6 at 3; CL 24–29 at 3–4. ISDA specifically commented that: The proposed expansion of the exemption to cover all bilateral agreements would ''enable market participants to focus on legal and economic substance rather than labels'' (CL 24–8 at 3); that the elimination of the requirement that exempt transactions not be standardized or fungible would ''eliminate a potential source of uncertainty with respect to the scope of the exemption'' (*id.*); that the authorization of clearing would ''eliminate the 'Hobson's Choice' that now exists between legal certainty and the use of clearing to reduce systemic risk'' (*id.*); and that the nonrepudiation provisions would deal directly with the ''main source of legal risk under the CEA'' (*id.* at 5). As ISDA noted, the substantial growth of the OTC swaps market since the Commission first promulgated part 35 in 1993:

> did not occur in a vacuum. It was fostered by this Commission in an earlier regulatory initiative commencing with the release of the Swaps Policy Statement in 1989 and continuing with the promulgation of the Swaps Exemption * * * and the Hybrids Exemption * * * These latter actions were of course entirely consistent with the intent of Congress, as reflected in the enactment of the Futures Trading Practices Act of 1992. * * * The pivotal role that OTC derivatives transaction [sic] now play in our economy is an outgrowth of these earlier policies of the Commission and the continuing expressions of support for those policies by Congress. ISDA believes that the proposed regulatory initiative now under consideration can and should be viewed as a vital and positive step in carrying out the Commission's long-standing policy with respect to OTC derivatives.
>
> ISDA believes that * * * the proposed regulatory initiative is an important change for the better. We applaud the sensitivity of both the Commission and its professional staff to the need to avoid structuring the proposals in ways that could result in legal *un*certainty, and we believe that the proposals *will not* have this effect. We likewise applaud the decision of the Commission to propose specific actions intended to increase, within the parameters of the CEA, legal certainty and we believe the proposals *will* have this effect. * * *

(CL 24–8 at 2; emphasis in original).

One commenter, however, the Regulatory Studies Program of the Mercatus Center (Mercatus), expressed the view that, by expanding the category of products to which the exemption applies, the Commission may exacerbate rather than reduce legal uncertainty. CL 24–21 at 4–5. Mercatus is concerned about the ''implications'' of the broad definitions used, commenting that, if adopted as proposed, the Commission could attempt to exercise its antifraud authority over contracts, agreements and transactions as to which it has no jurisdiction. *Id.* Mercatus suggests that the Commission instead limit the scope of part 35 to instruments over which the Act vests the Commission with jurisdiction, such as ''contracts of sale of a commodity for future delivery.'' *Id.* at 9.[13]

These amendments, however, do not expand the Commission's jurisdiction. To the contrary, the substance of part 35's scope provision remains unchanged from the current part 35 exemption.[14] Furthermore, the Commission's antifraud authority in rule 35.3, as proposed and as being adopted herein, is limited to ''*transactions and persons otherwise subject to those [antifraud] provisions*'' (emphasis added). Thus, the antifraud provisions will continue to apply only to those transactions already covered by them. The Commission's approach is consistent with how Congress intended the Commission to exercise its exemptive authority.[15]

[13] J.P. Morgan Securities Inc. (J.P. Morgan) raises jurisdictional issues similar to those raised by Mercatus, while specifically focusing on the Commission's proposed rules concerning exempt multilateral transaction execution facilities and recognized clearing organizations. CL 24–19 at 2–5. The Commission is responding to those comments more thoroughly in its companion releases on those matters.

[14] Commission rule 35.1(a) provides that the provisions of the exemption apply to any transaction ''*which may be subject to the Act*'' (emphasis added). The final rules amend this scope provision to incorporate a technical amendment which substitutes the phrase ''any contract, agreement or transaction'' for ''any swap agreement.'' This change merely conforms the formal statement of scope in rule 35.1(a) to the substantive provisions of the rule.

[15] When it adopted section 4(c) in 1992, the Conferees of the Congress stated:

> The Conferees do not intend that the exercise of exemptive authority by the Commission [under section 4(c)] would require any determination

Continued

Moreover, the contract nonrepudiation provision that the Commission is adopting today further removes any potential legal uncertainty. As one commenter, McDermott, Will & Emery, on behalf of Virginia Electric & Power Company, noted, this provision ''would prevent economically disappointed counterparties from bringing a private cause of action seeking to void the contract on the theory that it is illegal.'' CL 24–25 at 2. This provision, as ISDA commented, will reduce legal uncertainty because ''[it] deal[s] directly with the main source of legal risk under the CEA.'' CL 24–8 at 5.

The expansion of the exemption to cover all bilateral ''contracts, agreements and transactions'' was endorsed by most other commenters. As one commenter, Reuters Group PLC, noted, this amendment should permit a ''substantially broader range of transactions to enjoy a new level of legal certainty.'' CL 24–30 at 2. In this regard, the Commission believes that certain pending matters may now be considered within the context of the new regulatory framework.

Two commenters, a coalition of commercial and investment banks (the Coalition)[16] and the OTC Derivatives Products Committee of the Securities Industry Association (SIA), recommended two changes regarding the operation of the exemption. CL 24–31; CL 24–36. First, they suggested that the Commission delete the requirement of the exemption that, in cases where a transaction is not submitted for clearing,[17] the creditworthiness of the counterparty be a material consideration in entering into the transaction. These commenters believe that retention of the creditworthiness requirement for non-cleared transactions will create uncertainty and confusion as to what types of non-cleared transactions are permissible. The Commission agrees and has deleted the creditworthiness requirement from part 35.

The Coalition and SIA also recommended that rule 35.2(d) be amended to authorize explicitly the netting of deliveries or delivery obligations in connection with transactions pursuant to part 35. Currently, part 35 permits bilateral arrangements for the netting of *payment obligations.* It also permits multilateral arrangements for the netting of *payments* ''provided that the underlying gross obligations among the parties are not extinguished until all netted obligations are fully performed.'' 58 FR at 5591. SIA commented that many categories of OTC derivatives require or permit settlement by delivery, that it can see no policy reason for excluding netting of such deliveries while permitting netting of payments, and that permitting such netting would be consistent with the goal of reducing systemic risk for OTC derivatives. CL 24–36 at 10. In light of these comments, the Commission is clarifying that the types of netting agreements that are permissible under part 35 include arrangements for the netting of delivery obligations or deliveries, respectively. As is currently the case for multilateral netting of payments, multilateral netting of deliveries would be permitted provided that the underlying gross obligations among the parties are not extinguished until all netted obligations are fully performed.

ISDA, the Coalition and SIA suggested that the Commission clarify that the determination whether a party is an eligible participant is to be determined by whether there was a reasonable belief at the time the transaction was entered into that a party was an eligible participant. CL 24–8 at 3; CL 24–31 at 8; CL 24–36 at 8. The language of the exemption currently tracks the language of the statute, which provides that the Commission shall not grant an exemption under section 4(c) of the Act unless the Commission determines that the exempted transaction ''will be entered into solely between appropriate persons.'' 7 U.S.C. 6(c)(2)(B)(i). However, as the Commission noted when it adopted the swaps exemption in 1993 (58 FR at 5589; footnotes omitted):

> As the Act specifies that the swap agreement may only be ''entered into'' by appropriate persons, this determination is to be made at the inception of the transaction. Further, it is sufficient that the parties have a reasonable basis to believe that the other party is an eligible swap participant at such time.

Furthermore, the Commission notes that the nonrepudiation provision specifically exempts a party from a rescission action based solely on the failure of the agreement to comply with the terms of the exemption when that party entered into the agreement with an eligible participant or with a counterparty ''reasonably believed by such party at the time the transaction was entered into'' to be an eligible counterparty.[18]

As part of its proposed amendments to part 35, the Commission proposed to publish its Swaps Policy Statement as Appendix A to part 35 and to include its Swaps Policy Statement and its Statutory Interpretation Concerning Certain Hybrid Instruments (55 FR 13582 (April 11, 1990)) (Hybrid Interpretation) within the nonrepudiation provision. The commenters generally supported these proposals, but recommended that the Commission update the Swaps Policy Statement, provide additional relief regarding the Treasury Amendment (7 U.S.C. 2(ii)) and revise and update the Hybrid Interpretation. CL 24–31 at 14–16; CL 24–36 at 3–7. As the Commission has noted, nothing in these rules affects the continuing vitality of the Commission's existing exemptions, policy statements or interpretations. The Commission is persuaded, however, that these commenters have raised important issues which, although outside the scope of this rulemaking, should be addressed expeditiously. The Commission plans to address these issues through a separate rulemaking or other appropriate action.

B. Eligible Participants

A number of commenters suggested changes to the definition of ''eligible participant'' in rule 35.1. The Commission proposed applying the definition of eligible participant set forth in the 1993 swaps exemption[19] to the revised and amended bilateral transaction exemption in part 35. Two commenters, the Managed Funds Association (MFA) and the Futures

beforehand that the agreement, instrument, or transaction for which an exemption is sought is subject to the Act. Rather, this provision provides flexibility for the Commission to provide legal certainty to novel instruments where the determination as to jurisdiction is not straightforward.

H.R. Rep. No. 978, 102d Cong., 2d Sess. 82–83 (1992). The Commission did not make a determination in 1993 that the transactions that it was exempting under part 35 were or were not subject to its jurisdiction. The Commission similarly declined to make any such determination in proposing the current amendments to part 35 and will not make any such determination now.

[16] See note 8, *supra.*

[17] For rules pertaining to clearing, see part 39 which the Commission is adopting in a companion release in this edition of the **Federal Register**.

[18] The Commission has made a technical change to the nonrepudiation provision in rule 35.3(b) to make clear that the reasonable belief is to exist at the time the transaction is entered into. In addition, the Commission has reorganized the nonrepudiation provisions of section 35.3.

[19] That definition generally uses the list of ''appropriate persons'' set forth in section 4(c)(3)(A) through (J) of the Act, and utilizes the authority granted by section 4(c)(3)(K) to determine other persons to be appropriate persons (specifically, natural persons with total assets exceeding at least $10 million). The Commission placed certain financial and other limitations on various categories of appropriate persons, consistent with Congress' intent that the Commission may limit the terms of an exemption to some, but not all, of the listed categories of appropriate persons. See H.R. Rep. No. 978, 102nd Cong., 2d Sess. 79 (1992).

Industry Association (FIA), suggested that the Commission create a new category of eligible participant that would include certain large commodity trading advisors. CL 24–4 at 4; CL 24–12 at 11. Specifically, MFA and FIA suggested that commodity trading advisors (CTAs) with at least $25 million in assets under management be permitted to trade in all exempt markets on behalf of their customers, without regard to the individual customers' financial qualifications. FIA also suggested that registered investment advisers (IAs) with at least $25 million in assets under management be included in this category of eligible participant.

Several other commenters suggested additional modifications to the definition of eligible participant. ISDA, the Coalition, The EBS Partnership and SIA recommended that the definition of eligible participant be expanded to include several additional categories of financial institutions and to include agency transactions by eligible participants on behalf of other eligible participants. CL 24–8; CL 24–31; CL 24–34; CL 24–36. Certain commenters, including the California Power Exchange, the National Grain and Feed Association (NGFA) and the Weather Risk Management Association, suggested that the financial thresholds for corporations and other entities were too restrictive. CL 24–5; CL 24–10; CL 24–28. Other commenters, including the FIA, the Coalition and SIA, commented that the financial threshold for natural persons who enter into exempt transactions for risk management purposes should be reduced from a total asset test of $10 million to a total asset test of $5 million. CL 24–12; CL 24–31; CL 24–36. Finally, the National Futures Association suggested that the Commission impose a $5 million asset test on investment companies to conform the standard for those collective investment vehicles to that which applies to commodity pools. CL 24–4.[20]

After careful consideration of these comments, the Commission is modifying the definition of eligible participant to permit agency transactions by eligible participants on behalf of other eligible participants,[21] to include foreign banks and their U.S. branches and agencies and the regulated subsidiaries and affiliates of insurance companies within that definition and to include a $5 million asset test for investment companies (as is required for investment companies under the current part 36). The Commission will consider MFA's and NFA's suggestion that a new category of eligible participant be added for registered CTAs and IAs with at least $25 million in assets under management in conjunction with its subsequent review of relief for CPOs and CTAs.[22]

In response to the comments regarding expanding the categories of eligible financial institutions and reducing the financial thresholds for corporations and other entities, the Commission notes that the current definition of eligible participant contains a general corporate category, which itself contains alternative means of qualifying, and that this general corporate category enables many different types and sizes of entities (including financial institutions) to qualify as eligible participants under part 35. As the Coalition acknowledges (CL 24–31 at 6), many financial institutions that are not specifically encompassed by the definition of eligible participant fall within this general corporate category. The Commission believes that this general corporate category is an appropriate standard to determine corporate eligibility.[23]

C. Agricultural Trade Options

Finally, the NGFA and Cargill opined that the bilateral transaction exemption should be available for all transactions in the agricultural commodities enumerated in section 1a(3) of the Act, including agricultural trade options. CL 24–10 at 3; CL 24–15 at 1–2. The Commission is retaining in part 35 its reservation of rule 32.13 which governs trading in certain agricultural trade options at this time.[24] The Commission has not yet had sufficient experience with rule 32.13, which the Commission recently reconsidered and adopted (64 FR 68011 (December 6, 1999)), to determine whether the $10 million net worth level should be modified. Furthermore, at the time the Commission adopted that exemptive level it noted the lack of industry consensus on the issue. *Id.* at 68015. The Commission has no reason to believe that a greater level of consensus has been reached since that time.

The Commission reiterates that these amendments to the part 35 exemption are designed to enhance legal certainty. In adopting these amendments to part 35, the Commission is not making any determination that the exempted transactions are or are not subject to its jurisdiction. When it adopted section 4(c) in 1992, the Conferees of the Congress stated:

> The Conferees do not intend that the exercise of exemptive authority by the Commission [under section 4(c)] would require any determination beforehand that the agreement, instrument, or transaction for which an exemption is sought is subject to the Act. Rather, this provision provides flexibility for the Commission to provide legal certainty to novel instruments where the determination as to jurisdiction is not straightforward.[25]

Moreover, these changes in no way call into question any transaction undertaken under part 35 before the adoption of these amendments. In recognition of its continuing vitality and to assist the public in locating it, the Commission as proposed is incorporating its 1989 Swaps Policy

[20] Many commenters also suggested modifications to the Commission's proposed definition of ''multilateral transaction execution facility'' in part 36. These comments are addressed in a companion release being issued by the Commission today adopting final rules governing multilateral transaction execution facilities. In this regard, the Commission notes that the use of the term ''bilateral'' in the title of part 35 does not import any independent requirements regarding the exemption. Taken together, however, part 35 governing bilateral transactions and parts 36 through 38 governing multilateral transactions execution facilities are intended to be seamless in the sense that transactions that do not fall within the definition of multilateral transaction execution facility in part 36 will be considered to be bilateral.

[21] In light of this general agency authorization by eligible participants on behalf of other eligible participants, the Commission is deleting the language in paragraphs 35.1(b)(2)(i), (ix) and (x) which specifically authorizes certain entities such as banks and futures commission merchants that are eligible participants to act in an agency capacity on behalf of other eligible participants. See 7 U.S.C. 6(c)(3)(A), (I) and (J). This specific authorization is now unnecessary.

[22] In a companion release being issued in this edition of the **Federal Register**, however, the Commission has modified the access standards for CTAs to provide that CTAs with at least $25 million under management may trade on a recognized derivatives transaction facility through any registered futures commission merchant. Moreover, in response to the comments of the futures exchanges, in the same companion release being issued today, the Commission has modified the eligibility standards for recognized derivatives transaction facilities to include certain registered floor brokers and floor traders. The Commission, however, is retaining the existing eligibility standards for floor brokers and floor traders when entering into bilateral transactions under part 35 (and when trading on exempt multilateral transaction execution facilities).

[23] Furthermore, with regard to the comments suggesting that some of the financial thresholds in the definition are too restrictive, the Commission notes that the part 35 definition of eligible participant has worked well over the years and that the amounts in real terms are less restrictive than when the exemption was first adopted.

[24] Rule 32.13 includes its own exemption which imposes a different financial threshold than part 35. Under rule 32.13(g), an option is exempt from various regulatory requirements if, among other things, each party to the option has a net worth of not less than $10 million. The Commission has reserved the application of rule 32.13 in part 35, see rule 35.3(a), and it is that reservation to which NGFA and Cargill object.

[25] H.R. Rep. No. 978, 102d Cong., 2d Sess. 82–83 (1992).

Statement as Appendix A to part 35.[26] Finally, the Commission again affirms the continuing applicability of its Energy Interpretation and its Energy Exemption which are not being changed or altered in any way by these part 35 amendments.

III. Section 4(c) Findings

These rule amendments are being promulgated under section 4(c) of the Act, which grants the Commission broad exemptive authority. Section 4(c) of the Act provides that, in order to promote responsible economic or financial innovation and fair competition, the Commission may by rule, regulation or order exempt any class of agreements, contracts or transactions, either unconditionally or on stated terms or conditions from any of the requirements of any provision of the Act. For any exemption granted pursuant to section 4(c), the Commission must find that the exemption would be consistent with the public interest. For any exemption granted pursuant to section 4(c) from the requirements of section 4(a), the Commission must further find that the section 4(a) requirements should not be applied to the agreement, contract or transaction to be exempted, that the exemption would be consistent with the public interest and the purposes of the Act, that the agreement, contract or transaction to be exempted would be entered into solely between appropriate persons and that the exemption would not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the Act.[27]

No one commented directly on the Commission's section 4(c) findings. Two U.S. futures exchanges, the Chicago Board of Trade and the Chicago Mercantile Exchange, however, cautioned the Commission to ensure that traditional exchange markets would not be put at an unfair competitive disadvantage within this new regulatory regime contemplated by this and the Commission's companion **Federal Register** releases. CL 24–7 at 12–13; CL 24–17 at 13–14. In this regard, the Commission believes that the regulatory lines that it has drawn are necessary and appropriate to protect the public interests embodied in the Act. Under the framework as a whole, the degree of regulation will turn on whether the market is multilateral, whether the market participants are eligible and whether or not the commodity is susceptible to manipulation. The Commission believes that these are appropriate factors on which to base regulatory differences and that, within the framework, the exchanges will be able to fairly compete with the OTC market.

The proposed exemption for bilateral transactions is available only to appropriate persons. Moreover, these amendments to part 35 will promote financial innovation and fair competition and reduce systemic risk. The Commission further finds that these proposed amendments would have no adverse effect on any of the regulatory or self-regulatory responsibilities imposed by the Act. Finally, the Commission finds that these amendments are consistent with the public interest.

IV. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA), 5 U.S.C. 601 *et seq.*, requires that agencies, in promulgating rules, consider the impact of these rules on small entities. A small entity is defined to include, *inter alia,* a ''small business'' and a ''small organization.'' 5 U.S.C. 601(6).[28] The Commission previously has formulated its own standards of what constitutes a small business with respect to the types of entities regulated by it. The Commission has determined that contract markets, futures commission merchants, registered commodity pool operators, and large traders should not be considered small entities for purposes of the RFA.[29]

The Commission believes that it is unlikely that firms defined as small businesses under Section 3 of the Small Business Act could offer or be offered transactions subject to the part 35 exemption and thus be affected by the rules exempting such transactions. See 58 FR 5587, 5593 (January 22, 1993). Further, the amendments to part 35 that the Commission is adopting today remove the requirement that the exempt transactions not be fungible or standardized as to their material economic terms and makes the expanded relief available to a broader category of transactions.

Accordingly, the Chairman, on behalf of the Commission, certifies pursuant to section 3(a) of the RFA, 5 U.S.C. 605(b), that the amendments to part 35 will not have a significant economic impact on a substantial number of small entities. In this regard, the Commission notes that it did not receive any comments regarding the RFA implications of the amendments to part 35.

B. Paperwork Reduction Act

The Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3507(d)) imposes certain requirements on federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information as defined by the PRA. As the Commission noted in proposing these amendments, it has determined that the PRA does not apply to these amendments because they do not contain information collection requirements which require the approval of the Office of Management and Budget. No comments were received concerning the Commission's determination in this regard.

List of Subjects in 17 CFR Part 35

Commodity futures, Commodity Futures Trading Commission.

In consideration of the foregoing, and pursuant to the authority contained in the Commodity Exchange Act and, in particular, sections 2, 4, 4c, and 8a thereof, 7 U.S.C. 2, 6, 6c, and 12a, the Commission hereby revises part 35 of title 17 of the Code of Federal Regulations to read as follows:

PART 35—EXEMPTION OF BILATERAL AGREEMENTS

Sec.
35.1 Scope and definitions.
35.2 Exemption.
35.3 Enforceability.
Appendix A to Part 35—Policy Statement Concerning Swap Transactions

Authority: 7 U.S.C. 2, 6, 6c, and 12a.

§ 35.1 Scope and definitions.

(a) *Scope.* The provisions of this part shall apply to any contract, agreement or transaction which may be subject to the Act, and which has been entered into on or after October 23, 1974.

(b) *Definition.* As used in this part, ''eligible participant'' means, and shall be limited to, the following persons or classes of persons, either trading for their own account or through another eligible participant:

(1) A bank or trust company or a foreign bank or a branch or agency of a

[26] The Swaps Policy Statement originally was published at 54 FR 30694 (July 21, 1989). In this republication, the Commission has corrected certain typographical errors that appeared in the original publication.

[27] See 7 U.S.C. 6(c).

[28] ''Small organization,'' as used in the RFA, means ''any not-for-profit enterprise which is independently owned and operated and is not dominant in its field * * *.'' 5 U.S.C. 601(4). The RFA does not incorporate the size standards of the Small Business Administration for small organizations. Agencies are expressly authorized to establish their own definition of small organization. *Id.*

[29] 47 FR 18618–20 (Apr. 20, 1982).

foreign bank (as defined in section 1(b) of the International Bank Act of 1978 (12 U.S.C. 3101(b));

(2) A savings association or credit union;

(3) An insurance company that is regulated by a State or that is regulated by a foreign government and is subject to comparable regulation (including a regulated subsidiary or affiliate of such an insurance company);

(4) An investment company subject to regulation under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) or a foreign person performing a similar role or function subject as such to foreign regulation, *provided* that such investment company or foreign person is not formed solely for the specific purpose of constituting an eligible participant and has total assets exceeding $5,000,000;

(5) A commodity pool formed and operated by a person subject to regulation under the Act or a foreign person performing a similar role or function subject as such to foreign regulation, *provided* that such commodity pool or foreign person is not formed solely for the specific purpose of constituting an eligible participant and has total assets exceeding $5,000,000;

(6) A corporation, partnership, proprietorship, organization, trust, or other entity not formed solely for the specific purpose of constituting an eligible participant:

(i) Which has total assets exceeding $10,000,000, or

(ii) The obligations of which under the contract, agreement or transaction are guaranteed or otherwise supported by a letter of credit or keepwell, support, or other agreement by any such entity referenced in paragraph (b)(6) of this section or by an entity referred to in paragraph (b)(1), (2), (3), (4), (5), (6) or (8) of this section; or

(iii) Which has a net worth of $1,000,000 and enters into the agreement in connection with the conduct of its business; or which has a net worth of $1,000,000 and enters into the agreement to manage the risk of an asset or liability owned or incurred in the conduct of its business or reasonably likely to be owned or incurred in the conduct of its business;

(7) An employee benefit plan subject to the Employee Retirement Income Security Act of 1974 or a foreign person performing a similar role or function subject as such to foreign regulation with total assets exceeding $5,000,000, or whose investment decisions are made by a bank, trust company, insurance company, investment adviser subject to regulation under the Investment Advisers Act of 1940 (15 U.S.C. 80a–1 *et seq.*), or a commodity trading advisor subject to regulation under the Act;

(8) Any governmental entity (including the United States, any state, or any foreign government) or political subdivision thereof, or any multinational or supranational entity or any instrumentality, agency, or department of any of the foregoing;

(9) A broker-dealer subject to regulation under the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*) or a foreign person performing a similar role or function subject as such to foreign regulation: *Provided, however,* that if such broker-dealer is a natural person or proprietorship, the broker-dealer must also meet the requirements of either paragraph (b)(6) or (11) of this section;

(10) A futures commission merchant, floor broker, or floor trader subject to regulation under the Act or a foreign person performing a similar role or function subject as such to foreign regulation: *Provided, however,* that if such futures commission merchant, floor broker, or floor trader is a natural person or proprietorship, the futures commission merchant, floor broker, or floor trader must also meet the requirements of paragraph (b)(6) or (b)(11) of this section; or

(11) Any natural person with total assets exceeding at least $10,000,000.

§ 35.2 Exemption.

A contract, agreement or transaction is exempt from all provisions of the Act and any person or class of persons offering, entering into, rendering advice, or rendering other services with respect to such contract, agreement or transaction, is exempt for such activity from all provisions of the Act (except in each case the provisions enumerated in § 35.3(a)) provided the following terms and conditions are met:

(a) The contract, agreement or transaction is entered into solely between eligible participants either trading for their own account or through another eligible participant;

(b) The contract, agreement or transaction is not entered into and traded on or through a multilateral transaction execution facility as defined in § 36.1 of this chapter; and

(c) The contract, agreement or transaction, if cleared, is submitted for clearance or settlement to a clearinghouse that is authorized under § 39.2 of this chapter.

(d) The provisions of paragraphs (b) and (c) of this section shall not be deemed to preclude:

(1) Arrangements or facilities between parties to such contracts, agreements or transactions that provide for netting of payment or delivery obligations resulting from such contracts, agreements or transactions;

(2) Arrangements or facilities among parties to such contracts, agreements or transactions that provide for netting of payments or deliveries resulting from such contracts, agreements or transactions; or

(3) The use of an electronic or non-electronic market or similar facility used solely as a means of communicating bids or offers by market participants or the use of such a market or facility by a single counterparty to offer to enter into or to enter into bilateral transactions with multiple counterparties.

(e) Any person may apply to the Commission for exemption from any of the provisions of the Act (except section 2(a)(1)(B)) for other arrangements or facilities, on such terms and conditions as the Commission deems appropriate, including but not limited thereto, the applicability of other regulatory regimes.

§ 35.3 Enforceability.

(a) Notwithstanding the exemption in § 35.2, sections 2(a)(1)(B), 4b, and 4o of the Act, § 32.9 of this chapter as adopted under section 4c(b) of the Act, § 32.13 of this chapter, and sections 6(c) and 9(a)(2) of the Act to the extent that they prohibit manipulation of the market price of any commodity in interstate commerce or for future delivery on or subject to the rules of any contract market, continue to apply to transactions and persons otherwise subject to those provisions.

(b) A party to a contract, agreement or transaction that is with a counterparty that is an eligible participant (or counterparty reasonably believed by such party at the time the contract, agreement or transaction was entered into to be an eligible participant) shall be exempt from any claim, counterclaim or affirmative defense by such counterparty under section 22(a)(1) of the Act or any other provision of the Act:

(1) That such contract, agreement or transaction is void, voidable or unenforceable, or

(2) To rescind, or recover any payment made in respect of, such contract, agreement or transaction, based solely on the failure of such party or such contract, agreement or transaction to comply with the terms or conditions of the exemption under this part.

(c) A party to a contract, agreement or transaction that is entered into pursuant to the Statement of Policy Concerning Swap Transactions in appendix A to

this part 35 or the Statutory Interpretation Concerning Certain Hybrid Instruments, as the same may be revised by the Commission from time to time, shall be exempt from any claim under section 22(a)(1) of the Act or any other provision of the Act:

(1) That such contract, agreement or transaction is void, voidable or unenforceable, or

(2) To rescind, or recover any payment made in respect of, such contract, agreement or transaction, based solely on the failure of such party, or such contract, agreement or transaction, to comply with the Statement of Policy Concerning Swap Transactions in appendix A to this part 35 or the Statutory Interpretation Concerning Certain Hybrid Instruments, as the same may be revised by the Commission from time to time, respectively, or with any provision of the Act or other Commission rule or exemption, excluding, in the case of this paragraph, any claim for manipulation or fraud arising under a provision of the Act or Commission rules applicable by its terms to a contract, agreement or transaction that is not otherwise subject to regulation under the Act.

Appendix A to Part 35—Policy Statement Concerning Swap Transactions

(a) Background.

(1) Section 2(a)(1)(A) of the Commodity Exchange Act (CEA or Act) grants the Commission exclusive jurisdiction over ''accounts, agreements (including any transaction which is of the character of * * * an 'option' * * *), and transactions involving contracts of sale of a commodity for future delivery traded or executed on a contract market * * * or any other board of trade, exchange, or market. * * *'' 7 U.S.C. 2. The CEA and Commission regulations require that transactions in commodity futures contracts and commodity option contracts, with narrowly defined exceptions, occur on or subject to the rules of contract markets designated by the CFTC.[1] In several recent releases[2] and in response to requests for case-by-case review of various proposed offerings,[3] the Commission has addressed the applicability of the Act and Commission regulations to various forms of commodity-related instruments offered and sold other than on designated contract markets. An overview of off-exchange transactions and issues was commenced by issuance in December 1987 of an Advance Notice of Proposed Rulemaking (Advance Notice). The Advance Notice requested comment concerning, among other things, a proposed no-action position concerning certain commercial transactions, which, as described, would have extended to certain categories of swap transactions.

(2) Based upon careful review of the comments received in response to the Advance Notice, indicating generally a need for greater clarity in this area, representations from market users, and consultations with other federal regulators concerning the issues raised by swap transactions, the Commission is issuing this policy statement to clarify its view of the regulatory status of certain swap transactions. This statement reflects the Commission's view that at this time most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the Act and regulations. This policy statement is intended to recognize a non-exclusive safe harbor for transactions satisfying the requirements set forth in this Appendix.

(b) Safe harbor standards. (1) In determining whether a transaction constitutes a futures contract, the Commission and the courts have assessed the transaction ''as a whole with a critical eye toward its underlying purpose.''[4] Such an assessment entails a review of the ''overall effect'' of the transaction as well as a determination as to ''what the parties intended.''[5] Although there is no definitive list of the elements of futures contracts, the CFTC and the courts recognize certain elements as common to such contracts.[6] Futures contracts are contracts for the purchase or sale of a commodity for delivery in the future at a price that is established when the contract is initiated, with both parties to the transaction obligated to fulfill the contract at the specified price. In addition, futures contracts are undertaken principally to assume or shift price risk without transferring the underlying commodity. As a result, futures contracts providing for delivery may be satisfied either by delivery or offset.

(2) In addition to these necessary elements, the CFTC and the courts also recognize certain additional elements common to exchange-traded futures contracts, including standardized commodity units, margin requirements related to price movements, clearing organizations which guarantee counterparty performance, open and competitive trading in centralized markets, and public price dissemination.[7] These additional elements facilitate the trading of futures contracts on exchanges and historically have developed in conjunction with the growth of organized contract

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[1] 7 U.S.C. 6(a), 6c(b), 6c(c). Section 4(a) of the CEA provides, inter alia, that it is unlawful to enter into a commodity futures contract that is not made ''on or subject to the rules of a board of trade which has been designated by the Commission as a 'contract market' for such commodity.'' 7 U.S.C. 6(a). This prohibition does not apply to futures contracts made on or subject to the rules of a foreign board of trade, exchange or market. 7 U.S.C. 6(a). The exchange trading requirement reflects Congress's view that such an environment would control speculation and promote hedging. H.R. Rep. No. 44, 67th Cong., 1st Sess. 2 (1921). See also 7 U.S.C. 5 (Congressional findings concerning necessity for regulation of futures and commodity option transactions). Pursuant to sections 4c(b) and 4c(d), 7 U.S.C. 6c(b) and 6c(d), of the CEA, the Commission has authority to permit transactions in commodity options which do not take place on contract markets. Currently, only two narrow categories of such option transactions exist: trade options (in which the offeree is a ''commercial user'' of the underlying commodity) and dealer options (in which the grantor fulfills the criteria of section 4c(d)(1) of the CEA). See also 54 FR 1128 (January 11, 1989) (Proposed Rules Concerning Regulation of Hybrid Instruments). Final Rules Concerning Regulation of Hybrid Instruments.

[2] 52 FR 47022 (December 11, 1987) (Advance Notice of Proposed Rulemaking); 54 FR 1139 (January 11, 1989) (Statutory Interpretation Concerning Certain Hybrid Instruments); 54 FR 1128 (January 11, 1989) (Proposed Rules Concerning Regulation of Hybrid Instruments). See also 50 FR 42963 (October 23, 1985) (Statutory Interpretation and Request for Comments Concerning Trading in Foreign Currencies for Future Delivery).

[3] The Commission staff's Task Force on Off-Exchange Instruments has addressed a number of proposed offerings of hybrid instruments in a series of published ''no-action'' letters. See, *e.g.,* CFTC Advisory No. 39–88, June 23, 1988 [Interpretative Letter No. 88–10, June 20, 1988, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,262] (notes indexed to dollar/Yen exchange rate); CFTC Advisory No. 45–88, July 19, 1988 [Interpretative Letter No. 88–11, July 13, 1988, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,284] (notes indexed to dollar/Yen exchange rate); CFTC Advisory No. 48–88, July 26, 1988 [Interpretative Letter No. 88–12, July 22, 1988, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,285] (notes indexed to dollar/foreign currency exchange rate); CFTC Advisory No. 58–88, August 30, 1988 [Interpretative Letter No. 88–16, August 26, 1988, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,312] (federally-chartered corporation issuing notes indexed to nationally disseminated measure of inflation published by a U.S. government agency); CFTC Advisory No. 63–88, September 21, 1988 [Interpretative Letter No. 88–17, September 6, 1988, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,320] (fixed-rate debentures with additional payments indexed to the price of natural gas over an established base price); CFTC Advisory No. 66–88, September 23, 1988, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,321 (certificates of deposit with interest payable at maturity indexed in part to the spot price of gold). See also CFTC Advisory No. 18–19, March 17, 1989 (letter dated November 23, 1988, concerning proposed sale of hay for delayed delivery).

[4] CFTC v. Co Petro Marketing Group, Inc., 680 F.2d 573, 581 (9th Cir. 1982).

[5] CFTC v. Trinity Metals Exchange, No. 85–1482–CV–W–3 (W.D. Mo. January 21, 1986] [citing CFTC v. National Coal Exchange, Inc. [1980–1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,424 at 26,046 (W.D. Tenn. 1982)].

[6] See generally, 52 FR 47022, 47023 (December 11, 1987) (citing In the Matter of First National Monetary Corp., [1984–1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 (CFTC 1985)); Letter to the Honorable Patrick Leahy and the Honorable Richard Lugar, Committee on Agriculture, Nutrition and Forestry, United States Senate, from Wendy L. Gramm, Chairman, Commodity Futures Trading Commission, dated May 16, 1989 (Attachment at 7–8). The Commission has explained that this does not mean that ''all commodity futures contracts must have all of these elements * * *'' In re Stovall, [1977–1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 (CFTC 1979). To hold otherwise would permit ready evasion of the CEA.

[7] E.g., Advance Notice, 52 FR 47023; Letter to the Honorable Patrick Leahy and the Honorable Richard Lugar, Committee on Agriculture, Nutrition and Forestry, United States Senate, from Wendy L. Gramm, Chairman, Commodity Futures Trading Commission, dated May 16, 1989 (Attachment at 8); OGC Statutory and Regulatory Interpretation (Regulation of Leverage Transactions and Other Off-Exchange Future Delivery-Type Instruments), 50 FR 11656, 11657, n.2 (March 25, 1985); CFTC v. Co Petro Marketing Group, Inc., 680 F.2d 573 (9th Cir. 1982).

markets. The presence or absence of these additional elements, however, is not dispositive of whether a transaction is a futures contract.[8]

(3) In general, a swap may be characterized as an agreement between two parties to exchange a series of cash flows measured by different interest rates, exchange rates, or prices with payments calculated by reference to a principal base (notional amount).[9] Commenters have described the swap market as one in which the customary large transaction size effectively limits the market to institutional participants rather than the retail public.[10] Market participants also have noted that swaps typically involve long-term contracts, with maturities ranging up to twelve years.[11] In addition to these characteristics, many comparisons between swaps and futures contracts have stressed the tailored, non-standardized nature of swap terms; the necessity for particularized credit determinations in connection with each swap transaction (or series of transactions between the same counterparties); the lack of public participation in the swap markets; and the predominantly institutional and commercial nature of swap participants. Other commenters have stressed that, despite these distinctions in the manner of trading of swaps and exchange products, the economic reality of swaps nevertheless resembles that of futures contracts.

(4) The Commission recognizes that swaps generally have characteristics, such as individually-tailored terms, predominantly commercial and institutional participants, and expectation of being held to maturity, rather than offset during the term of the agreement, that may warrant distinguishing them from futures contracts. The criteria set forth in this Appendix identify certain swaps for which regulation under the CEA and Commission regulations is unnecessary. These safe harbor standards are consistent with policies reflected in the CEA's jurisdictional exclusion for forward contracts,[12] the Treasury Amendment,[13] and the trade option exemption,[14] and are otherwise consistent with section 2(a)(1)(A) of the CEA. Although these jurisdictional and exemptive or exclusionary provisions are not sufficiently broad to provide clear exemptive boundaries for many swaps, they reflect policies relevant to the safe harbor policy set forth in this Appendix and may encompass certain swap transactions.[15]

(5) Consequently, the Commission has determined that a greater degree of clarity may be achieved through safe harbor guidelines establishing specific criteria for swap transactions to which the Commission's regulatory framework will not be applied. Swaps satisfying the requirements set forth in this Appendix will not be subject to regulation as futures or commodity option transactions under the Act and regulations. This policy statement addresses only swaps settled in cash, with foreign currencies considered to be cash.[16]

(i) Individually-tailored terms. (A) Individual tailoring of the terms of swap agreements is frequently cited as indispensable to the operation of the swap market. Commenters have indicated that swap agreements are based upon individualized credit determinations and are tailored to reflect the particular business objectives of the counterparties. Tailoring occurs through private negotiations between the parties and may involve not only financial terms but issues such as representations, covenants, events of default, term to maturity, and any requirement for the posting of collateral or other credit enhancement. Such tailoring and counterparty credit assessment distinguish swap transactions from exchange transactions, where the contract terms are standardized and the counterparty is unknown. In addition, the tailoring of swap terms means that, unlike exchange contracts, which are fungible, swap agreements are not fully standardized.

(B) To qualify for safe harbor treatment, swaps must be negotiated by the parties as to their material terms, based upon individualized credit determinations, and documented by the parties in an agreement or series of agreements that is not fully standardized.[17] This requirement is intended to exclude from safe harbor treatment instruments which are fungible and therefore may be readily transferred and traded.

(ii) Absence of exchange-style offset. (A) Exchange-traded futures contracts generally

[8] In addition, the Commission and the courts have consistently recognized that ''the requirement that a futures contract be executed on a designated contract market is what makes the contract legal, not what makes it a futures contract.'' In the Matter of First National Monetary Corp., [1984–1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 at 30,975 (CFTC 1985); In re Stovall, [1977–1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 at 23,776 (CFTC 1979). See, also, Interpretative Statement, ''The Regulation of Leverage Transactions and Other Off-Exchange Future Delivery Type Investments-Statutory Interpretation,'' 50 FR 11656 (March 25, 1985).

[9] See generally, Bank for International Settlements, Recent Innovations in International Banking at 37–60 (April 1986); S.K. Henderson, ''Swap Credit Risk: A Multi-Perspective Analysis,'' 44 Business Lawyer 365 (1989). Interest rate swaps have been described as having three primary forms: coupon swaps (fixed rate to floating rate swaps); basis swaps (swap of one floating rate for another floating rate); and cross-currency interest rate swaps (swaps of fixed rate payments in one currency to floating rate payments in another currency). Currency swap transactions involve agreements between two parties providing for exchanges of amounts in different currencies which are calculated on the basis of a pre-established interest rate, a specified exchange rate, and a specified notional amount. Commodity swaps generally include swap transactions similar in structure to interest rate swaps, except that payments are calculated by reference to the price of a specified commodity, such as oil.

[10] The average notional amount for swaps has been estimated at $24 million. Letter from the New York Clearing House to CFTC, dated April 6, 1989, commenting on Proposed Rule and Statutory Interpretation Concerning Certain Hybrid and Related Instruments.

[11] E.g., Letter to CFTC from the International Swap Dealers Association, Inc., dated April 8, 1988, concerning Advance Notice; letter to CFTC from Morgan Guaranty Trust Company of New York, dated April 11, 1988, concerning Advance Notice.

[12] Section 2(a)(1)(A) of the CEA provides that the term ''future delivery'' does not include sales of any cash commodity for deferred shipment or delivery. 7 U.S.C. 2. Sales of cash commodities for deferred delivery, or forward contracts, generally have been recognized to be commercial, merchandising transactions in physical commodities entered into by commercial counterparties who have the capacity to make or take delivery of the underlying commodity but in which delivery ''may be deferred for purposes of convenience or necessity.'' 52 FR 47027; In re Stovall, [1977–1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 at 23,777–78 (CFTC 1979). The forward contract exclusion may apply to certain types of swap transactions.

[13] The Treasury Amendment provides that ''[n]othing 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.'' 7 U.S.C. 2. See generally, 50 FR 42963 (October 23, 1985) (CFTC Statutory Interpretation). See also, Commodity Futures Trading Commission v. American Board of Trade, 473 F. Supp. 117 (S.D.N.Y. 1979), aff'd, 803 F.2d 1242 (2d Cir. 1986). The Treasury Amendment may apply to some types of transactions also characterized as swaps.

[14] The trade option exemption, which is set forth in Rule 32.4(a), 17 CFR 32.4(a) (1988), authorizes commodity option transactions, other than those on commodities specified in rule 32.2(a), that are not executed on a designated contract market and that are:

Offered by a person which has a reasonable basis to believe that the option is offered to a producer, processor, or commercial user of, or a merchant handling the commodity which is the subject of the commodity option transaction, or the products or byproducts thereof, and that such producer, processor, commercial user or merchant is offered or enters into the commodity option transaction solely for purposes related to its business as such. It should be noted that under Rule 32.4(a), only the offeree of the trade option need qualify as a ''commercial user'' or ''merchant.'' Rule 32.4(a) is silent concerning which party to a trade option may be the option buyer of a put or call or ''long,'' and which party may be the option seller of a put or call or ''short.'' As a result, provided that the qualifying commercial offeree is entering the trade option transaction solely for non-speculative purposes demonstrably related to its commercial business in the commodity which is the subject of the option transaction, the requirements of Rule 32.4(a) are met.

[15] The forward contract exclusion facilitates commodity transactions within the commercial merchandising chain. The trade option exemption similarly may be viewed as facilitating principal-to-principal transactions in which the offeree is a commercial party with respect to the underlying commodity. The Treasury Amendment reflects Congressional intent to avoid duplicative regulation of foreign currency transactions and other transactions in the interbank market supervised by bank regulatory agencies.

[16] As noted previously, certain categories of swap transactions may be subject to the forward contract exclusion, the Treasury Amendment and the trade option exemption. The safe harbor criteria set forth in this Appendix apply equally to options on swaps.

[17] Formation of swaps pursuant to a master agreement between two counterparties that establishes some or all contract terms for one or more individual swap transactions between those counterparties is not precluded by this requirement, provided that material terms of the master agreement and transaction specifications are individually tailored by the parties.

may be terminated by offset,[18] that is, liquidated through establishment of an equal and opposite position. For exchange-traded futures contracts, the universal counterparty to each cleared position is the clearing organization. Prior consent of the clearing organization, as counterparty, is unnecessary to offset.[19]

(B) In contrast, swap transactions have been described as transactions which create performance obligations terminable only with counterparty consent and which generally are expected to be maintained to maturity. A swap counterparty who seeks to eliminate the economic effect of a swap agreement may enter into a reverse swap agreement, that is, a second swap with the same maturity and payment requirements, with the same or a new counterparty, but in which the party seeking to eliminate its economic exposure assumes the reverse position (in this case the obligations of each party to both transactions continue to maturity). A swap counterparty who seeks to terminate, absent default, its obligations under a swap agreement may: Undertake a swap sale in which, based upon consent of the counterparty, it assigns its rights and obligations under the swap to a third party or negotiate an early termination of the transaction, or swap ''closeout,'' in which it negotiates a lump-sum payment with its counterparty to terminate the swap.[20] In the latter two cases, termination of the obligations created by a swap is dependent upon consent of the counterparty.

(C) To qualify for safe harbor treatment, the swap must create obligations that are terminable, absent default, only with the consent of the counterparty. If consent to termination is given at the outset of the agreement and a termination formula or price fixed, the consent provision must be privately negotiated. This requirement is intended to confine safe harbor treatment to instruments that are not readily used as trading vehicles, that are entered into with the expectation of performance, and that are terminated as well as entered into based upon private negotiation.

(iii) Absence of clearing organization or margin system. (A) As noted in paragraph (b)(5)(ii) of this Appendix, the necessity for individualized credit determinations has been described as a hallmark of swap transactions. A number of commenters have stressed both the dependence of the current swap market on such determinations and the absence of a multilateral ''credit support'' mechanism, such as a clearing organization, for swaps. In accordance with the concept of swaps as dependent upon private negotiation and individualized credit determinations as to the capacity of certain parties to perform, this safe harbor is applicable only to swap transactions that are not supported by the credit of a clearing organization and that are not primarily or routinely supported by a marked-to-market margin and variation settlement system designed to eliminate individualized credit risk.[21] The ability to impose individualized credit enhancement requirements to secure either changes in the credit risk of a counterparty or increases in the credit exposure between two counterparties consistent with the criteria in paragraph (b)(5)(ii) would not be affected.

(B) [Reserved]

(iv) The Transaction is Undertaken in Conjunction With a Line of Business.

(A) The absence of public participation in the swaps market has frequently been cited as a factor supporting different regulatory treatment of swaps and futures contracts. Swap market participants are predominantly institutional and commercial entities such as corporations, commercial and investment banks, thrift institutions, insurance companies, governments, and government-sponsored or chartered entities.[22]

(B) The safe harbor set forth in this Appendix is limited to swap transactions undertaken in conjunction with the parties' line of business.[23] This restriction is intended to preclude public participation in qualifying swap transactions and to limit qualifying transactions to those based upon individualized credit determinations. This restriction does not preclude dealer transactions in swaps undertaken in conjunction with a line of business, including financial intermediation services.

(v) Prohibition Against Marketing to the Public. Swap transactions eligible for safe harbor treatment may not be marketed to the public. This restriction reflects the institutional and commercial nature of the existing swap market and the Commission's intention to restrict qualifying swap transactions to those undertaken as an adjunct of the participant's line of business.

(c) Conclusion. This policy statement is intended to clarify the regulatory treatment of certain transactions in order to facilitate legitimate market transactions in a field distinguished by innovation and rapid growth. Consequently, the Commission proposes to continue to review on a case-by-case basis transactions that do not meet the criteria set out in this Appendix and that are not otherwise excluded from Commission regulation.

Issued in Washington, DC, this 21st day of November, 2000, by the Commission.

Jean A. Webb,

Secretary of the Commission.

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[18] In the context of exchange-traded futures, offset refers to the liquidation of a futures position through the acquisition of an opposite position. Availability of such offset, resulting in the liquidation of the position, typically is established by exchange rules governing exchange members' relationships with the clearing house. See, e.g., Chicago Mercantile Exchange Rule 808 (''a clearing member long or short any commodity to the Clearing House as a result of substitution may liquidate the position by acquiring an opposite position for its principal''); Board of Trade Clearing Corporation Regulation 705.00 (''Where a member buys and sells the same commodity for the same delivery, and such contracts are cleared through the Clearing House, the purchases and sales shall be offset to the extent of their equality, and the member shall be deemed a buyer from the Clearing House to the extent that his purchases exceed his sales, or a seller to the Clearing House to the extent that his sales exceed his purchases''); New York Futures Exchange Rule 3–4 (''As between the Clearing Corporation and the original parties to futures contracts and option contracts, such contracts shall be binding upon the original parties until liquidated by offset, delivery, exercise or expiration, as the case may be''). Of course, the ability to offset in any given case depends upon the availability of a counterparty to enter into an offsetting transaction at an acceptable price.

[19] However, the ability to liquidate contractual positions through offset is established by clearing organization rules to which all clearing members consent.

[20] Swap parties may agree in advance upon a termination formula or price for the swap.

[21] Several commenters urged the Commission to adopt a safe harbor for swaps that would be conditioned upon, among other things, the absence of a credit support mechanism. See Letter to CFTC from Sullivan & Cromwell, dated April 8, 1988, concerning Advance Notice, at 41–42; Letter to CFTC from Manufacturers Hanover, dated April 11, 1988, concerning Advance Notice, at 4. The safe harbor standard is based upon individualized credit determinations at the outset and during the pendency of the contract.

[22] Letter dated April 8, 1988, to CFTC from International Swap Dealers Associations, Inc. concerning Advance Notice.

[23] Swap transactions entered into with respect to exchange rate, interest rate, or other price exposure arising from a participant's line of business or the financing of its business would be consistent with this standard.