UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

KHORRAM PROPERTIES, LLC v. McDONALD INVESTMENTS, INC.	CFTC Docket No. 04-R045 ORDER GRANTING INTERLOCUTORY REVIEW

This matter is before us on the Respondent's application for interlocutory review in a reparations proceeding that has been stayed pending review. The legal issue presented is whether the Commission's Policy Statement Concerning Swap Transactions ("Policy Statement"), issued July 17, 1989, governs an interest rate swap that is the subject matter of the parties' dispute.[1] Respondent contends that the Policy Statement operates to deprive the Commission of jurisdiction over the transaction. Complainant asserts that the Policy Statement has been superseded by amendments to the Act. The Administrative Law Judge ("ALJ") ruled in Complainant's favor in denying both Respondent's motion to dismiss and its motion to certify the question for Commission review. We grant the application and dismiss the complaint.

[1] *See Policy Statement Concerning Swap Transactions*, 54 Fed. Reg. 30694 (July 21, 1989), *reprinted in* [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,494 (CFTC July 21, 1989). The statement creates a non-exclusive safe harbor for qualifying swaps pursuant to Section 2(a)(1)(A) of the Commodity Exchange Act ("Act" or "CEA"), which grants the Commission exclusive jurisdiction over futures transactions.

Relying on Commission and judicial precedent, the Commission specified that swap agreements would not be regulated as futures contracts if they had: (1) individually-tailored terms; (2) an absence of exchange-style offset; (3) an absence of a clearing organization or margin system; (4) been undertaken in conjunction with the parties' lines of business; and (5) not been marketed to the public. *Id.* at 36,145-47.

BACKGROUND

The Complainant, Khorram Properties, LLC ("Khorram"), owns and operates a 42-unit apartment complex in Bellevue, Washington. At the time it entered into the swap, Khorram was in the business of constructing the apartment complex and had borrowed $5,671,000 from KeyBank National Association ("KeyBank") for this purpose. As part of the loan, Khorram and KeyBank entered into the swap to lock in an interest rate for the permanent financing that Khorram knew it would need when construction was completed and the construction loan was repaid through a permanent, long-term loan. The swap's notional value was the same as the amount of the construction loan, *i.e.*, $5,671,000. It was confirmed on June 2, 2000.

Upon termination of the swap three years later, a settlement payment of $1,461,232 was due from Khorram to KeyBank. Khorram made the payment on June 2, 2003, but later brought this reparations complaint to recover the amount of the payment, naming as respondents KeyBank; McDonald Investments, LLC, an introducing broker affiliated with KeyBank ("McDonald"); and several individuals. The Office of Proceedings forwarded Khorram's complaint only to McDonald, because McDonald was the sole registrant under the Act named in the complaint.

Khorram has claimed throughout this proceeding that the swap it entered into with KeyBank is an illegal, off-exchange futures contract. According to Khorram, swap agreements are futures contracts under the Act and the two means to lawfully offer swaps are through CEA

Section 2(g)[2] and Part 35 of the Commission's regulations.[3] Khorram argues that Section 2(g) and Part 35 became law after the Policy Statement was issued and therefore have operated to supersede its original terms. It contends that the swap it entered into with KeyBank does not comply with either Section 2(g) or Part 35, and is therefore illegal. Its assertion of illegality rests on the contention that swaps may be entered into only by parties who qualify either as "eligible swap participants" under Rule 35.1(b)(2) or as "eligible contract participants" under CEA Section 1a(12). These two provisions define the classes of persons permitted to participate in those swap transactions governed, respectively, by Part 35 and CEA Section 2(g). Khorram claims it does not qualify under either provision.

McDonald defends on the grounds that the original terms of the Policy Statement remain in force and provide a third way whereby qualifying swaps may be lawfully offered. It asserts that its swap with Khorram complied with the terms of the Policy Statement. McDonald contended that qualifying swaps under the Policy Statement are not regulated as exchange-traded futures, and therefore are not subject to the Commission's reparations jurisdiction under Section 14 of the Act. Accordingly, McDonald filed a motion asking the ALJ to dismiss Khorram's complaint.

On March 28, 2005, the ALJ denied McDonald's motion to dismiss, without explanation, and also refused either to certify the jurisdictional question for Commission review or to stay the

---

[2] Section 2(g) was added to the Act by the Commodity Futures Modernization Act of 2000 ("CFMA"), Appendix E to Pub. L. No. 106-554, § 105(b), 114 Stat. 2763 (2000). It excludes qualifying swap contracts from the Act, except for certain reserved provisions.

[3] Section 4(c), a general grant of exemptive authority, was added to the Act by the Futures Trading Practices Act of 1992 ("1992 Act"). Pursuant to its authority under Section 4(c), the Commission adopted Part 35 of its rules on January 14, 1993. Part 35 exempts qualifying swaps "which may be subject to the Act, and which ha[ve] been entered into on or after October 23, 1974" from all provisions of the Act except those specified in Part 35. *See* Commission Regulations 35.1(a), 35.2. *See also Exemption for Certain Swap Agreements*, 58 Fed. Reg. 5587, *reprinted in* [1992-1994 Transfer Binder], Comm. Fut. L. Rep. (CCH) ¶ 25,539 (CFTC Jan. 22, 1993)("Part 35 Rule Approval").

proceedings while McDonald applied for interlocutory review notwithstanding the ALJ's refusal to certify. On April 22, 2005, we took review and stayed the case to consider McDonald's application.

DISCUSSION

This appeal presents an issue of first impression in our reparations forum. We reject Khorram's argument that the Policy Statement is obsolete for several reasons. Contrary to Khorram's assertion that McDonald is "dredging up a long past standard" as a defense, the Commission has never withdrawn the Policy Statement and expressly reaffirmed it on its original terms in 1993 and 1998. *See Part 35 Rule Approval*, ¶ 25,539 at 39,588-89 n.11; *see also Over-the-Counter Derivatives*, 63 Fed. Reg. 26114, *reprinted in* [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,282 (CFTC May 12, 1998) ("Concept Release"). In approving the Part 35 rules, the Commission stated that the Policy Statement would remain in effect and that swaps market participants could continue to rely upon it for existing and new swaps. Part 35 Rule Approval, *supra*, at 39,588-89 n.11. The Commission reaffirmed the Policy Statement's viability five years later in the Concept Release. The Concept Release summarized the Policy Statement and reiterated that all applicable exemptions, interpretations, and policy statements issued by the Commission concerning over-the-counter derivative contracts remained in effect, and that market participants could continue to rely upon them.[4]

As McDonald contends, the Commission's reaffirmation of the Policy Statement in the Part 35 Rule Approval and in the Concept Release demonstrates that the 1992 Act did not touch

[4] Khorram also argues that a 1997 comment letter by the Commission to the Securities and Exchange Commission demonstrated that the Policy Statement was "gone" and "subsumed" by Part 35. *See Complainant's Opposition* at 8. Because the Commission reaffirmed the validity of Swaps Policy Statement one year later in the 1998 Concept Release, the 1997 letter cannot be viewed as a withdrawal or abandonment of the Policy Statement.

upon the continued validity of the safe harbor created by the Policy Statement.[5] The treatment of swaps under the Commission's Part 35 rules is not at cross-purposes to the treatment of qualifying swaps under the Policy Statement. They are non-exclusive, complementary sources of regulatory relief.[6] We also find Khorram's argument that Congress enacted legislation in 2000 overruling the Policy Statement to be unfounded. Section 2(g) was added to the Act when the CFMA was signed into law on December 21, 2000. It does not apply retroactively to the Khorram-KeyBank swap agreement, confirmed June 2, 2000. Our inquiry under Section 2(g) stops there.[7]

Overall, Khorram misapprehends the Commission's and Congress's shared concern with preventing legal uncertainty.[8] The approach taken by the Commission in the Policy Statement is

---

[5] In 1998, Congress took the unusual step of temporarily prohibiting the CFTC from taking any regulatory action to alter the Swaps Policy Statement, which it mentioned by name and by Federal Register citation. *See* H.R. 4328, Omnibus Appropriations Act, 105th Cong. § 760, (Oct. 21, 1998), *reprinted in* [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,431. Subsection (e) of this appropriations bill stated that nothing in it should be construed as "reflecting or implying a determination" that a qualifying swap agreement under the Policy Statement was subject to the CEA.

[6] Congress intended that Section 4(c) would add to the Commission's ability to enhance legal certainty for swaps and other off-exchange instruments without requiring any determination that such instruments were subject to the CEA. When Section 4(c) was adopted in 1992, the bill's conferees 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.

See H.R. Rep. No. 978, 102d Cong., 2d Sess. 82-83 (1992).

[7] The CFMA does not speak in terms of retroactive application. Absent a clear indication from Congress that it intended the CFMA to have retroactive application, we conclude that the CFMA does not apply to the Khorram-KeyBank swap. *Hughes Aircraft Co. v. Schumer*, 520 U.S. 939, 947-49 (1997) (barring a defense available before statute's effective date violates presumption against retroactivity); *Landgraf v. USI Film Products*, 511 U.S. 244 (1994) (absent a statutory statement to the contrary, a presumption against retroactivity applies); *see also Cary Oil, Inc. v. MG Refining & Marketing, Inc.*, [2002-2003 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,213 (S.D.N.Y. 2002) (under *Landgraf*, CFMA does not apply retroactively).

[8] In the legislative history of the CFMA, the House Financial Services Committee defined the term "legal uncertainty" as the risk that the CFTC or a court might determine that a particular class of swap agreement is an illegal, off-exchange futures contract. The Committee recounted steps taken by the Commission to reduce this risk.

consistent with the incremental, step-by-step approach that Congress continued to follow in the 1992 and 2000 reauthorizations.[9] We reject Khorram's argument that the Policy Statement is outdated because of subsequent legal developments. Because the Policy Statement governs this transaction, whether Khorram qualifies as an eligible swap participant under Part 35 or an eligible contract participant under Section 2(g) is not relevant to our inquiry.

* * *

Khorram makes the separate argument that even if the Policy Statement remains valid generally, it does not provide a safe harbor in this case because the Khorram-KeyBank swap does not qualify under its terms. Khorram states that McDonald's motion to dismiss "entirely fails to address" this aspect of this case. *Complainant's Opposition to Respondent's Motion to Dismiss* at 1 (Mar. 14, 2005) ("*Complainant's Opposition*").

Khorram reasons that if its transaction is not a qualifying swap within the meaning of the Policy Statement, it is *ipso facto* an illegal futures contract cognizable in the reparations

---

The Committee stated:

> Legal uncertainty for derivatives has for years been of particular concern to the Committee. Outdated statutes that raise questions about the enforceability of contracts with banks and bar improvements in the ways banks reduce risk pose a palpable threat to the safety and soundness of the financial system. U.S. banking regulators warn that uncertainties and unintended consequences associated with the CEA could potentially turn financial disruptions in the global system into financial disasters.
>
> The CFTC itself has tried to address these serious concerns. In 1989 the CFTC established, in its Swaps Policy Statement, that swaps are not appropriately regulated as futures. Since then, the CFTC has generally adhered to this policy in its actions. In addition, no Federal agency, no court, and no Congress has ever found that swaps are futures. As a result, the de facto reality is that swaps have never been regulated as futures under the CEA. Every day banks write an enormous volume of swaps contracts that are sustained by this consensus.

See Commodity Futures Modernization and Financial Contract Netting Improvement Act of 2000, H.R. Rep. No. 106-711 (II), at 54-55 (Sept. 6, 2000).

[9] In this regard, we observe that Congress has chosen not to amend Section 2(a)(1)(A), the statutory basis for the Policy Statement, in the three reauthorization cycles completed since 1989. When Congress revisits a statute giving rise to a well-known administrative interpretation without pertinent change, the congressional failure to revise or repeal the agency's interpretation is persuasive evidence that the interpretation is the one intended by Congress. *See CFTC v. Schor*, 478 U.S. 833, 846 (1986).

forum. It contends that whether its swap meets the requirements of the Policy Statement is a fact-based issue that requires further development of the record below. Thus, it contends, McDonald's motion to dismiss is premature. Our review of the record, however, reveals no material factual dispute that the Khorram-KeyBank swap qualifies under the terms of the Policy Statement.

As stated above, *see supra* note 1, swap agreements will not be regulated as futures contracts if they have: (1) individually-tailored terms; (2) an absence of exchange-style offset; (3) an absence of a clearing organization or margin system; (4) have been undertaken in conjunction with the parties' lines of business; and (5) are not marketed to the public. *Policy Statement,* ¶ 24,494 at 36,145-47. No dispute exists with respect to three of the five requirements: absence of exchange-style offset, absence of a clearing or margin system, and the fact that the swap was undertaken in connection with a line of business. Although Khorram argues that the other factors—"individually tailored terms" and "not marketed to the general public"—have not been met, we conclude that McDonald has demonstrated that these factors have been satisfied as well.

Khorram contends that the swap lacked individually tailored terms because it was memorialized on an ISDA form agreement. Khorram also argues that the notional amount and interest rate were set by the market rather than by the parties, and were therefore not individually tailored. These arguments lack merit. In issuing the Policy Statement, the Commission said that the requirement for "individually tailored terms" does not preclude use of a master agreement, provided the material terms of the master agreement and transaction specifications are individually tailored by the parties. *See Swaps Policy Statement*, ¶ 24,494 at 36,145-46 n.17.

The Khorram-KeyBank swap contained material individually-tailored terms, namely, the notional amount and the settlement date. The notional amount was $5,671,000, which was the precise amount of KeyBank's loan to Khorram, and the settlement date of June 2, 2003 was chosen as the date when Khorram was expected to need permanent financing. The interest rate was based on a future settlement date unique to Khorram, determined by its individual refinancing needs. Moreover, Khorram's principals and their spouses were required to guarantee the swap. As McDonald points out, nothing in the record shows that KeyBank ever wrote another swap with these precise terms, which were tied to Khorram's loan or its refinancing needs.

Khorram also failed to rebut McDonald's showing that its swap was not marketed to the public. McDonald submitted sworn evidence that it marketed swaps only to commercial loan customers of KeyBank in connection with anticipated or closed loans. Khorram's specific swap could not have been marketed to the public since its terms were uniquely tied to Khorram's loan, and Khorram's principals and their spouses were required to guarantee the swap. Khorram has offered no evidence to controvert this showing.

Khorram's only argument on this point is that it was not an institutional participant in the swaps market, but rather was a customer of KeyBank seeking a loan, with no experience in stocks, bonds or derivatives. The Policy Statement expressly contemplates such circumstances. It states in pertinent part:

> The safe harbor set forth herein 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.

¶ 24,494 at 36,147. Footnote 23 states: "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." *Id.* The KeyBank-Khorram swap falls squarely within the scope of the Policy Statement. Unlike Part 35 and Section 2(g), which define the classes of persons eligible to enter into swaps under their authority, and establish financial qualifications for swap participants, the Policy Statement focuses on the nature and purpose of the transaction.

Khorram borrowed $5,671,000 from KeyBank for the commercial purpose of constructing an apartment complex, and the swap was transacted with KeyBank to lock in a rate index for refinancing the commercial loan when construction was completed. Khorram was therefore within that limited class of persons to which McDonald marketed swaps, and its assertion that it lacked experience in stocks, bonds, and derivatives does not determine the availability of the safe harbor. We conclude that the record reflects without credible contradiction from Khorram that neither its swap, nor KeyBank swaps in general, were marketed to the public. Because all requirements of the Policy Statement have been met, the safe harbor applies, and the swap lies outside our regulatory authority.

* * *

Finally, we address Khorram's procedural argument against interlocutory review. This case reached us from the ALJ's denial of McDonald's motion to dismiss. Khorram argues that McDonald's pleading, although titled a "motion to dismiss," should be treated as a motion for summary disposition because McDonald cited to facts contained in various documents of record. *See Complainant's Response to Respondent's Application for Interlocutory Review* at 3 (April 12, 2005). Khorram reasons that these citations to fact "convert[ed]" McDonald's motion into a

summary disposition motion. Under Rule 12.310(f), "[a]n application for interlocutory review of an order denying a motion for summary disposition shall not be allowed."

We disagree with this analysis. Rule 12.308(c)(2), governing motions to dismiss, provides that an ALJ's decision must be based "[u]pon consideration of the whole record." Under the express terms of the rule, McDonald was entitled to rely on facts as they appeared of record when it filed its dismissal motion. It is apparent that the parties had conducted a considerable amount of discovery and McDonald in its motion has relied on the record developed through discovery. McDonald's use of these jurisdictional facts (which are not subject to material dispute, as discussed above), does not "convert" its dismissal motion under Rule 12.308 into a summary disposition motion under Rule 12.310. Khorram gives too little weight to the fact that McDonald's motion challenges our subject matter jurisdiction. Since we cannot decide claims that fall outside the reach of our authority, it is appropriate that jurisdictional issues be raised promptly and resolved at the earliest opportunity. *Motzek v. Monex Int'l Ltd.*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,095 (CFTC June 1, 1994); *Stucki v. American Options Corp.*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,559 at 22,286 n.19 (CFTC Feb. 13, 1978).[10]

[10] While McDonald's application for interlocutory review has been pending before the Commission, Khorram has filed several motions seeking to introduce material that it received from the Commission pursuant to the Freedom of Information Act. Although these submissions are not contemplated by the rules governing interlocutory review, we have examined them and determined that they are essentially cumulative of points and authorities contained in the parties' pleadings, and do not bear on the outcome of our decision. *See Sommerfeld v. Aiello*, [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,271 at 50,650 n. 36 (CFTC Sept. 29, 2000). Accordingly, Khorram's motions are denied.

CONCLUSION

For the foregoing reasons, we find that the transaction in dispute in this case lies beyond the jurisdictional reach of Section 14. In this extraordinary circumstance, we grant respondent's petition for interlocutory review and dismiss the complaint.

IT IS SO ORDERED.[11]

By the Commission (Chairman JEFFERY and Commissioners LUKKEN, BROWN-HRUSKA, HATFIELD, and DUNN).

Jean A. Webb
Secretary of the Commission
Commodity Futures Trading Commission

Dated: October 13, 2005

[11] Under Sections 6(c) and 14(e) of the Commodity Exchange Act (7 U.S.C. §§ 9 and 18(e) (2000)), a party may appeal a reparation order of the Commission to the United States Court of Appeals for only the circuit in which a hearing was held; if no hearing is held, the appeal may be filed in any circuit in which the appellee is located. The statute states that such an appeal must be filed within 15 days after notice of the Commission order, and that any appeal is not effective unless, within 30 days of the effect of the order, the appealing party files with the clerk of the court a bond equal to double the amount of the reparation award.