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(1)

Katten
KattenMuchinRosenman LLP

525 W. Monroe Street
Chicago, IL 60661-3693
312.902.5200 tel
312.902.1061 fax

KEVIN M. FOLEY
kevin.foley@kattenlaw.com
312.902.5372 direct
312.577.8724 fax

COMMENT

By Electronic Mail

July 8, 2008

Mr. Robert Wasserman
Associate Director
Division of Clearing and Intermediate Oversight
Commodity Futures Trading Commission
1155 21st Street NW
Washington DC 20581

Re: CBOT Request Involving Cleared-Only Denatured Fuel Ethanol Swaps and Options

Dear Bob:

On behalf of the Executive Committee of the Law and Compliance Division of the Futures Industry Association ("Executive Committee"), I want to thank the staff of the Division of Clearing and Intermediary Oversight ("Division") for providing us the opportunity at this late date in the process to submit these comments with respect to the petition of the Chicago Board of Trade ("CBOT") to commingle customer funds used to margin CBOT contracts executed in OTC markets, and cleared by the Chicago Mercantile Exchange ("CME") on behalf of the CBOT, with other funds held in customer segregated funds ("Petition"). We ask that this letter be included in the comment file on the Commission's request for comment on the Petition.

We want to emphasize that our concerns are not with the end result that the CBOT, CME and Division staff seek to achieve. We support efforts to enhance the protection of customer funds employed in trading derivatives transactions, whether on exchange or OTC. Our concerns lie only with the means by which the parties would realize this goal.

The CBOT Petition differs in one critical respect from similar petitions earlier filed by the New York Mercantile Exchange ("NYMEX") with respect to OTC contracts in energy products cleared through Clearport and by the CME with respect to certain OTC Eurodollar contracts and foreign currency contracts cleared through the CME. In each of the two latter petitions, the applicable rules provide that the OTC contracts are to be converted to futures contracts when accepted for clearing through exchange of futures for swaps ("EFS") procedures. Thus, the

contracts carried on the books and records of the respective clearing organization and clearing member futures commission merchant ("FCM") are futures contracts and the funds held to margin, guarantee or secure such contracts are properly customer segregated funds under section 4d(a)(2) of the Commodity Exchange Act ("Act").[1]

If the CBOT Petition had provided that the OTC ethanol contracts would convert to futures contracts when accepted for clearing, we would have welcomed the proposal without comment. However, for reasons that are not entirely clear, we understand that Commission staff dissuaded the CBOT from incorporating an EFS procedure in its proposal to clear OTC ethanol swaps. As a result, in contrast to the NYMEX OTC energy contracts and the CME OTC Eurodollar and foreign currency contracts that are converted to futures contracts when accepted for clearing, the OTC ethanol swaps will remain OTC swaps. In light of the serious legal and policy concerns discussed below, we strongly encourage the Commission staff to reconsider its position.[2]

Division staff and we agree that, under the Commodity Broker Liquidation provisions of the Bankruptcy Code ("Code"), Subchapter IV of Chapter 7, a person trading OTC cleared-only contracts through an FCM is entitled to a priority in the event of a commodity broker default, only if that person is a ***"customer"*** under the Code, which, in turn, requires the person to hold a claim against the defaulting FCM on account of a ***"commodity contract"***. We disagree, however, with the staff's conclusion that a cleared swap can be a commodity contract under Subchapter IV.

As we have discussed, the Executive Committee is concerned that, unless the OTC contracts are converted to futures contracts when accepted for clearing, they will not be ***"commodity contracts"***. Our analysis follows.

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1 *See*, Order, Treatment of Funds Held in Connection with the Clearing of Over-the-Counter products by the New York Mercantile Exchange, dated May 30, 2002; and Order, Treatment of Funds Held in Connection with the Clearing of Over-the-Counter products by the Chicago Mercantile Exchange, dated March 3, 2006.

By letter dated September 11, 2007, ICE Clear U.S., Inc. has filed a similar petition with respect to OTC contracts in coffee, sugar and cocoa. As with NYMEX and the CME, the rules of ICE Clear U.S., Inc. would provide that the OTC contracts would be converted to futures contracts when accepted for clearing. By Federal Register release dated July 7, 2008, the Commission has requested comment on a petition that the CME and CBOT have filed to clear certain OTC contracts in agricultural products. We have not had an opportunity to review that submission. However, we understand that, as with the ethanol swaps, the CME and CBOT have not proposed to convert these contracts to futures contracts when accepted for clearing. As discussed below, we request that the Commission defer acting on the instant Petition at least until the comment period with respect to this latter petition has closed on August 21 has closed and the Commission has had an opportunity to consider any comments that may be received in response to the Commission's request for comment.

2 Even in the absence of such concerns, a consistent approach among derivatives clearing organizations with respect to the treatment of cleared swaps contracts and the funds deposited to margin, guarantee or secure such contracts will enhance legal certainty and reduce the risk of customer confusion.

A ***"customer"*** is defined in section 761(9) of the Code to mean:

> **(A)** with respect to a futures commission merchant— **(i)** entity for or with whom such futures commission merchant deals and that holds a claim against such futures commission merchant on account of a ***commodity contract*** made, received, acquired, or held by or through such futures commission merchant in the ordinary course of such futures commission merchant's business as a futures commission merchant from or for the commodity futures account of such entity; or
>
> **(ii)** entity that holds a claim against such futures commission merchant arising out of—
>
> **(I)** the making, liquidation, or change in the value of a commodity contract of a kind specified in clause (i) of this subparagraph;
>
> **(II)** a deposit or payment of cash, a security, or other property with such futures commission merchant for the purpose of making or margining such a commodity contract; or
>
> **(III)** the making or taking of delivery on such a commodity contract.

A ***"commodity contract"***, in turn, is defined in section 761(4) to mean, in relevant part:

> **(A)** with respect to a futures commission merchant, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade;
>
> **(B)** with respect to a foreign futures commission merchant, foreign future;
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> * * *
>
> **(D)** with respect to a clearing organization, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization, or commodity option traded on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization[.]

Under the provisions of Subchapter IV, therefore, a cleared OTC swap transaction is a ***"commodity contract"*** only if it is determined to be a "contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade." Under the Act, of course, a "contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade" is generally understood to be a futures contract.

We agree that, under section 761(8) of the Code, the term ***"contract market"*** includes, by reference to section 1a(29) of the Act, a derivative clearing organization ("DCO"). Therefore, a

contract for the purchase or sale of a commodity for future delivery that is not executed on a designated contract market but is cleared through a DCO may be a ***"commodity contract"*** under the Code. We disagree only with the staff's conclusion, as set forth in the excerpt of the draft interpretation that staff provided to us on July 3, that a swap contract, "when cleared through a DCO, . . . would be considered a 'commodity contract' [*i.e.*, a contract for the purchase or sale of a commodity for future delivery] under section 761(4) of the Bankruptcy Code."

Staff's conclusion is based, in part, on the fact that, "[w]hen cleared, [swaps] are subject to performance bond requirements, daily variation settlement, the potential for offset, and final settlement procedures that are substantially similar, and often identical, to those applicable to exchange-traded products at the same clearinghouse." An additional, and determining, factor underlying the staff's analysis, which we understand from our conversation with Division staff on July 3, is the DCO's decision to request the Commission to issue an order under section 4d(a)(2) of the Act authorizing the DCO and its FCM clearing members to hold customer funds posted with the DCO and FCM to margin cleared-only swap transactions in a customer segregated account. That is, if the DCO requests authority to hold the funds in a customer segregated account, the cleared swap will be considered a commodity contract for purposes of the Code; if the DCO does not make such a request, the cleared swap will not be a commodity contract.

In sum, we understand staff's position to be that the Commission has the authority, upon the request of a DCO, to determine that a cleared swap contract, which is not converted to a futures contract when accepted for clearing, is nonetheless a "contract for the purchase or sale of a commodity for future delivery," *i.e.*, a futures contract, solely for the purpose of Subchapter IV of the Code. Further, in staff's view, the Commission's determination in this regard would not alter the Commission's refusal to date—since at least 1989—to hold that OTC swap contracts are contracts for the purchase or sale of a commodity for future delivery.[3]

We respectfully disagree. We submit that a Commission interpretation holding that a cleared swap is a contract for the purchase or sale of a commodity for future delivery solely for purposes of the Bankruptcy Code—and no other—would constitute an amendment to the definition of a ***"commodity contract"*** under the Code to include, essentially, such other contracts cleared by a registered derivatives clearing organization as the Commission, in its sole discretion, may

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[3] Congress similarly has declined to take a position that swaps are "contracts for the purchase or sale of a commodity for future delivery." For example, in adopting section 4(c) of the Act in the Futures Trading Practices Act of 1992, Congress authorized the Commission to exempt swap transactions "to the extent such agreements may be regarded as subject to the provisions of this Act." Section 4(c)(5) of the Act. More recently, in the Commodity Futures Modernization Act ("CFMA"), Congress added section 2(g) to exclude swap transactions generally from the provisions of the Act.

Although the Commission may have jurisdiction under section 5b of the Act over the clearing of swap contracts through a clearing organization that has elected to register as a DCO for this purpose, such authority by itself does not change the essential characteristics of swap transactions or convert them to contracts for the purchase or sale of a commodity for future delivery.

determine.[4] Under the provisions of section 20(b) of the Act, however, the Commission is not authorized to amend the definition of a ***"commodity contract."*** Consequently, in the event of a commodity broker default, a swap participant's claim that it is a ***"customer"*** under Subchapter IV would be subject to challenge, thereby delaying the distribution of assets to futures customers and preventing the transfer of the defaulting commodity broker's customer accounts to a non-defaulting FCM.

Even if the Commission, as a matter of law, were able to split the baby in this manner, we do not believe that it should do so as a matter of policy. A cleared swap is either a contract for the purchase or sale of a commodity for future delivery or it is not. Legal certainty would be significantly undermined if the Commission were to hold that a cleared swap could be a contract for the purchase or sale of a commodity for future delivery for purposes of the Bankruptcy Code only, but not for purposes of the Act, the statute that Congress has charged the Commission with enforcing. The resulting legal uncertainty would be exacerbated by the fact that the proposed interpretation would vest in a DCO the decision on whether a cleared swap would be viewed as a contract for the purchase or sale of a commodity for future delivery for purposes of the Code, a decision that would be based not on the essential characteristics of the contract, but on the DCO's preference for the account in which the collateral supporting these contracts should be held.[5]

We respectfully submit that the Commission should not adopt such a position at this time, without requesting additional public comment. As the staff is aware, the recent events involving credit default swaps and other OTC products has led to an increasing interest, in particular among the Commission's colleagues on the President's Working Group, in establishing a

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[4] We do not believe that the Commission's 2004 Interpretative Statement Regarding Funds Determined to be Held in the Futures Account Type of Customer Account Class, 69 Fed.Reg. 69510 (November 30, 2004) supports staff's position. The underlying circumstances are substantially different. There, the Commission held that, where the Commission had issued an order authorizing funds that would otherwise be held in a secured amount account under Commission rule 30.7 to be held in a customer segregated account under Commission rule 1.20, foreign futures customers would be treated as futures customers in the event of the FCM's default. However, in contrast to a swap transaction, a foreign futures is a commodity contract under the Code. Therefore, the Commission was not expanding the scope of contracts clearly defined as commodity contracts under the Code.

Further, the Commission generally prohibited an FCM from commingling foreign futures and foreign options funds in a customer segregated account out of "concern that to permit such commingling would possibly dilute the pool of funds available to U.S. futures customers in the event of a bankruptcy of the futures commission merchant to the extent funds located overseas could not be repatriated." In the circumstances in which the Commission has authorized such commingling, all foreign futures and options funds are required to be held in the US with either a US FCM or a DCO. As a result, the Commission's primary reason for prohibiting the commingling of US futures and foreign futures accounts, *i.e.*, the concerns that funds held overseas would not be repatriated, thus diluting the pool of available assets to meet US futures customer claims, was successfully addressed.

[5] Thus, for example, at the CME, ethanol swaps would be carried in the customer segregated account, while OTC contracts to be cleared through Swapstream would be carried in the clearing member's house account for the benefit of its customers. Yet, we understand that the CME intends to manage the risk associated with these products in essentially the same manner. Both products will be subject to performance bond requirements, daily variation settlement, the potential for offset, and final settlement procedures.

structure that would encourage the clearing of OTC products. Moreover, in addition to the OTC commodity products discussed above, The Clearing Corporation and the Depository Trust and Clearing Corporation have announced a credit default swap clearing facility; ICE has purchased Creditex Group with a view toward enhancing OTC processing; the CME currently clears OTC foreign currency transactions through FXMarketSpace; and the Commission itself has directed the staff to prepare a proposal with respect to the clearing of OTC agricultural swaps.

In these circumstances and in the interest of legal certainty, we believe the treatment of cleared swap contracts in the event of a default of a swap participant should be addressed in a comprehensive manner by the several financial regulatory authorities. Cleared swap contracts should not be subject to different Bankruptcy Code treatment simply because the contracts are cleared at different clearing organizations. Nor should the bankruptcy treatment result in competitive advantages for one clearing organization. No less important, having instructed its staff to develop a proposal for cleared agricultural swaps, the Commission should not inadvertently pre-empt its own consideration of the most appropriate way to protect customer collateral deposits with respect to cleared agricultural swaps, which consideration we assume will include an opportunity for public comment and participation. At the very least, therefore, as noted earlier, we would ask the Commission to defer any action on this Petition until the comment period with respect to the petition of the CME and CBOT certain OTC agricultural swaps closes on August 21, and the Commission has had an opportunity to consider any comments that may be filed.

We close this letter as we began it. We support the Commission's efforts to enhance the protection of customer funds deposited as collateral for cleared OTC swap transactions and look forward to working with the Commission and the staff to this end. We believe the most efficient way to achieve this shared goal in the near term, without having to address the legal and policy concerns above, is for the staff to reconsider its position with respect to the use of EFS procedures and encourage the CBOT to amend its rules to provide that OTC ethanol swaps will convert to futures contracts when accepted for clearing by the CME. We urge the staff to do so.

Thank you again for affording us the opportunity to submit these comments. If you have any questions concerning the matters discussed above, please contact Barbara Wierzynski, FIA's General Counsel, at (202) 466-5460, or me at (312) 902-5372.

With best regards,

Kevin M. Foley

cc: Honorable Walter Lukken, Acting Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner

Division of Clearing and Intermediary Oversight
Ananda Radhakrishnan, Director
John Lawton, Deputy Director and Chief Counsel
Phyllis Dietz, Associate Director

Office of the General Counsel
Terry Arbit, General Counsel

Division of Market Oversight
Richard Shilts, Director

Office of the Secretariat
David Stawick

CME Group
Dean Payton, Managing Director and Chief Regulatory Officer
Anne Polaski, Associate Director and Regulatory Counsel

Barbara Wierzynski, General Counsel, Futures Industry Association