

# **RECOMMENDATIONS FOR REFORM OF THE COMMODITY EXCHANGE ACT**

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# TRANSMITTAL LETTER

## ACCOMPANYING RECOMMENDATIONS FOR REFORM OF THE COMMODITY EXCHANGE ACT

*Honorable Thomas Ewing  
Chairman, Subcommittee on Risk  
Management and Specialty Crops  
Committee on Agriculture  
United States House of Representatives  
Washington, D.C. 20515*

**May 18, 1999**

Dear Chairman Ewing:

We appreciate your continuing commitment to modernization of the Commodity Exchange Act (CEA) and the opportunity to participate in your CEA Working Group on April 28, 1999. At the conclusion of the meeting, you asked all participants to provide you with written materials on the subjects discussed. This letter and the enclosed memorandum respond to your request.

As we emphasized during the working group discussion, CEA reform is critical in order to enhance competition in the U.S. market and abroad and to ensure the availability of a broad range of risk management tools to U.S. businesses and government agencies. This requires a modernized CEA that provides legal and regulatory certainty for financial contracts, reduces unnecessary regulatory burdens on the futures exchanges, and fosters financial innovation. We are committed to working with the Congress, the relevant regulatory agencies, and others in the private sector to achieve these objectives.

One subject discussed at the working group meeting was the proposal for CEA reform submitted by the Chicago Board of Trade (CBOT) and the Chicago Mercantile Exchange (CME). That proposal contains some features on which there is broad consensus, including the need to provide legal certainty that over-the-counter derivatives are not subject to the CEA and the need to reduce the regulatory burdens on the futures exchanges. We are concerned, however, that the CBOT-CME proposal seeks to achieve these goals within a framework that we believe will inevitably lead to unnecessary and burdensome regulation of additional categories of financial transactions and additional categories of participants in those transactions. We are also concerned that the CBOT-CME

proposal may well create a new round of legal and regulatory uncertainties through repeal of the Treasury Amendment and the introduction of new concepts to distinguish those transactions and participants that would be regulated under the CEA from those that would not be so regulated.

We intend the enclosed proposals for reform as constructive contributions to the dialogue on CEA reform and we look forward to the opportunity to explore them in greater detail with you and your congressional colleagues, as well as with other interested parties.

Very truly yours,

*Ad Hoc Coalition of Commercial and  
Investment Banks*

*American Bankers Association*

*ABA Securities Association*

*Emerging Markets Traders Association*

*The Foreign Exchange Committee*

*Futures Industry Association*

*International Swaps and Derivatives  
Association*

*Securities Industry Association*

*The Bond Market Association*

*The Financial Services Roundtable*

# RECOMMENDATIONS FOR REFORM OF THE COMMODITY EXCHANGE ACT

MEMORANDUM OF MAY 18, 1999

## PRINCIPLES FOR REFORM

The Commodity Exchange Act (CEA) should be modernized to provide legal and regulatory certainty for financial contracts, to encourage financial innovation, and to facilitate competition in the United States and abroad. A modernized CEA should foster efficient, liquid, and low-cost financial transactions.

Regulatory burdens that increase the cost or reduce the availability of essential risk management tools should be imposed only if Congress determines that other, less burdensome means, including market discipline, have not been effective in addressing the relevant public policy concerns.

U.S. businesses benefit when they are able to choose among different risk management tools, and the continued development of a diverse array of risk management tools will be enhanced by different regulatory approaches, including private regulation through market discipline.

## APPROACH TO REFORM

The foregoing objectives can be achieved most effectively by recasting the CEA both to assure “bright line” legal certainty for all transactions and reduced regulatory burdens for all market participants. Such an approach could readily accommodate proposals to modernize exchange regulation and promote market innovation and legal certainty.

The widely shared goals of legal certainty for over-the-counter transactions and regulatory relief for the futures exchanges could also be achieved through such measures as the clarification of exclusions and targeted regulatory reforms. If Congress adopts an incremental approach to reform, we recommend that it pursue that approach in accordance with the recommendations set forth below.

## OVERVIEW OF RECOMMENDED AMENDMENTS TO CEA

### 1. Excluded Transactions

#### A. Over-the-Counter Contracts

- The existing administrative exemption for swaps should be transformed into a statutory exclusion with modifications that incorporate more objective criteria for exclusion.
- In particular, it should be clarified that the exclusion applies to any category of principal-to-principal over-the-counter transaction, including transactions involving nonexempt securities, between eligible counterparties and contracts that are not part of a fungible class of instruments that are freely transferable without counterparty consent or subject to automatic rights of offset through transactions with third parties.
- It should also be clarified that otherwise qualified over-the-counter contracts do not become subject to regulation under the CEA merely because of the use of clearing and settlement arrangements to mitigate risk.

#### B. Hybrid Instruments

- Hybrid instruments that are predominantly securities or depository instruments should be excluded from regulation under the CEA.
- “Predominance” should be determined based on the Commodity Futures Trading Commission’s existing exemption for hybrid instruments and statutory interpretation concerning hybrid instruments.

- The exclusion should apply equally to hybrid instruments involving nonexempt securities.

### **C. Treasury Amendment**

- The Treasury Amendment should be retained and should be modified to clarify its original purpose. In particular, it should be clarified that the Treasury Amendment excludes all transactions involving the enumerated products that are not conducted on organized futures exchanges—whether or not the transactions are conducted on electronic trading facilities or are subject to clearing and settlement arrangements.
- Further clarification should also be provided with respect to the scope of products covered by the Treasury Amendment.
- Consideration should also be given to the need for additional legislative provisions to ensure a statutory remedy for fraud committed against retail market participants by bucket shops.

## **2. Electronic Trading**

- An increasingly broad range of electronic facilities are available in the marketplace. Not all of these are trading systems. There is also a broad range of electronic trading systems.
- Some electronic trading systems are organized futures exchanges and should be regulated as such, recognizing that electronic trading provides inherent protections that reduce the need for regulation and offer an opportunity to reduce regulatory burdens.
- Electronic facilities that are not trading systems do not require regulation under the CEA and many electronic trading systems likewise do not require regulation under the CEA or under other statutory schemes.

- Some electronic trading systems should perhaps be subject to regulation, but regulation that is less extensive than that applicable to organized futures exchanges. It should be possible for these electronic trading systems to be regulated by agencies other than the Commodity Futures Trading Commission (the specific agency perhaps depending on whether the underlying is a security, interest rate product, physical commodity, etc., or on geographic location).

## **3. Clearing**

Where oversight of clearing is appropriate, a U.S. regulator should be able to rely on the oversight performed by any other Group of Seven regulator and should not impose duplicative regulation or make preemptive assertions of jurisdiction.

## **4. Derivatives Dealers**

There should be no regulation under the CEA for derivatives dealers.

## **5. Regulatory Relief for Organized Exchanges**

Broad regulatory relief for the organized exchanges is desirable and should be provided to the maximum extent such relief is consistent with prudent public policy and does not jeopardize CEA reform.

## **6. Shad-Johnson Accord**

Any amendments to the Shad-Johnson Accord permitting broader exchange trading of futures on nonexempt securities should be subject to the following principles:

- The appropriate role(s) of the Commodity Futures Trading Commission or the Securities and Exchange Commission should be defined by the bona fide policy issues raised by the specific activities.
- Such amendments must not jeopardize CEA reform.