

The Commodity Futures Modernization Act of 2000

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Commodity Futures Modernization Act of 2000 was signed into law on December 21, 2000 and contains provisions affecting the regulatory and supervisory roles of the Commodity Futures Trading Commission and the Securities and Exchange Commission. This article provides background information on the Act, an analysis of the changes to the derivative and commodities markets and a summary of specific provisions of the Act.

Overview

The Commodity Futures Modernization Act of 2000 (the “Act”), approved by Congress on December 15, 2000 and signed into law by President Clinton on December 21, 2000, contains provisions affecting the regulatory and supervisory roles of the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (the “SEC”). Two of these changes are of particular importance to the derivatives and commodities markets. First, the Act clarifies that certain over-the-counter (“OTC”) derivatives transactions are outside of the jurisdiction of the CFTC. Second, under certain conditions, the Act allows trading of futures contracts based on single stocks and narrowly-based stock indices, with oversight being shared by the CFTC and the SEC.

The Act consists of four titles. Title I contains most of the changes to the Commodity Exchange Act (the “CEA”), including most of the amendments that limit the scope of the CEA. Title II amends the Securities Act of 1933 (the “Securities Act”), the Securities Exchange Act of 1934 (the “Exchange Act”), the CEA and the Shad-Johnson Jurisdictional Accord (the “Shad-Johnson Accord”), to provide the implementing rules necessary for shared

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oversight by the SEC and the CFTC of single stock futures trading. Title III provides additional legal certainty for swap agreements by providing guidelines for SEC regulation of equity based swaps. Title IV further limits the scope of the CEA by providing that nothing in the CEA applies to certain swap agreements (including credit and equity swaps), hybrid instruments and other products commonly offered by banks.

Background

OTC Derivatives Transactions

The CEA requires that futures contracts¹ must be traded on a CFTC regulated exchange, unless a statutory exclusion or regulatory exemption from such requirement can be found. Thus, if a futures contract should, under the CEA, be traded only on a CFTC regulated exchange, but nonetheless is traded over-the-counter, that futures contract is illegal and unenforceable. Historically, there has been some legal uncertainty as to whether either the CFTC or a court might rule particular swap agreements or other OTC derivatives transactions to be illegal off-exchange futures contracts.

Prior to the enactment of the Act, these concerns were heightened by the steady convergence of exchange-traded and OTC derivatives instruments. In recent years, the sheer volume of OTC derivatives transactions and the use of industry-developed master agreements have blurred some of the distinctions between exchange-traded and OTC derivatives instruments. Today, OTC derivatives frequently serve an economic function almost identical to that served by futures contracts. Moreover, as pointed out in a report released in November 1999 by the President's Working Group on Financial Markets, innovations such as electronic trading and the development of derivatives clearing systems created the potential to blur the distinction even further, and "alter the legal status of otherwise exempted or excluded instruments."

The Shad-Johnson Accord and the Ban on Single Stock Futures

The Shad-Johnson Accord was entered into in 1982 between the

¹The CEA does not contain a definition of "futures contract," referring instead to "contracts of sale of a commodity for future delivery."

SEC and the CFTC and subsequently codified by Congress to clarify the jurisdictions of the SEC and CFTC over security-based options and futures. The Accord addressed uncertainties concerning the regulation of securities-based derivatives products and granted to the SEC sole authority to regulate options on securities, certificates of deposit and stock groups. The regulation of futures and options on futures on exempted securities and broad-based stock indices was left to the CFTC.

Summary of Selected Provisions of the Act

The following is a summary of selected provisions of the Act that may be of particular interest to participants in the derivatives and commodities markets:

Specified Commodities, Excluded Commodities and Exempt Commodities

Eligible Contract Participants. Whether a transaction qualifies for the new exclusions and exemptions created under the Act usually depends on whether the transaction is entered into by “Eligible Contract Participants” as defined in the Act. The Act’s definition of Eligible Contract Participant replaces the concept of “eligible swap participant” that existed under the CFTC rules prior to adoption of the Act, and expands the range of persons who are eligible to make use of the new exclusions and exemptions created by the Act. Under the CEA, as amended by the Act, the term Eligible Contract Participants includes:

- (a) regulated financial institutions;
- (b) regulated insurance companies;
- (c) regulated investment companies;
- (d) regulated commodity pools with total assets in excess of \$5 million;
- (e) a corporation, partnership, trust or other business entity that either (A) has total assets in excess of \$10 million, (B) enters into transactions that are guaranteed by certain other Eligible Contract Participants, or (C) in the case of a transaction that relates to the conduct of the entity’s business, has a net worth in excess of \$1 million;
- (f) employee benefit plans that have total assets in excess of \$5 million and have their investment decisions made by certain independent advisers;
- (g) governmental entities that either (A) transact with certain other Eligible Contract Participants, (B) own and invest on a discretionary basis more

than \$25 million of assets, or (C) regularly enter into transactions with respect to the underlying commodity;

- (h) regulated broker-dealers (except that individuals or proprietorships that are broker-dealers must meet certain minimum net worth or other conditions);
- (i) regulated futures commission merchants (except that individuals or proprietorships that are futures commission merchants must meet certain minimum net worth or other conditions);
- (j) CEA-regulated floor brokers or traders in connection with transactions that take place on or through CEA-regulated or CEA-exempt boards of trade;
- (k) individuals with total assets in excess of \$10 million (or \$5 million in the case where the transaction relates to the risk management of an asset or liability of the individual); and
- (l) any other person the CFTC determines to be eligible in light of the financial or other qualifications of the person.

The definition of Eligible Contract Participant also includes certain brokers or investment advisers acting on behalf of an Eligible Contract Participant.

Clarifying the Treasury Amendment: Exclusions for Certain Transactions in Foreign Currency, Government Securities and Certain Other Commodities ("Specified Commodities"). Several provisions of the Act clarify the so-called "Treasury Amendment," which was the subject of much uncertainty and litigation. These provisions generally exclude transactions in Specified Commodities from CFTC regulation, other than (1) transactions conducted on an Organized Exchange², or (2) foreign currency transactions between unregulated entities and persons who are not Eligible Contract Participants.³ They also give the CFTC jurisdiction over retail foreign currency futures and options transactions that are not regulated by another federal regulator so that, among other things, the CFTC can take enforcement action against illegal bucket shops.

Exclusion for Certain Transactions in Excluded Commodities. Under the Act, the CEA generally does not apply to any transaction in an Excluded Commodity (as defined below) if the transaction is

²Under the CEA, as amended by the Act, the term Organized Exchange generally means a Trading Facility (see footnote 4) that permits trading by (1) persons who are not Eligible Contract Participants or (2) other than on a principal to principal basis.

³The exceptions described in clauses (1) and (2) do not apply to foreign currency option transactions conducted on national securities exchanges (which are excluded from regulation under the CEA).

(1) entered into between Eligible Contract Participants and is not conducted on a Trading Facility⁴ or (2) between Eligible Contract Participants, trading on a principal-to-principal basis, and the transaction is conducted on an Electronic Trading Facility.⁵ As a result, a broad range of OTC derivative transactions will be excluded from regulation under the CEA.

Excluded Commodities are defined to include:

- (1) an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure;
- (2) any other rate, differential, index, or measure of economic or commercial risk, return, or value that is either (A) not based in substantial part on the value of the narrow group of commodities not described in clause (1) above or (B) based solely on one or more commodities that have no cash market;
- (3) any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant transaction; or
- (4) an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in clause (1)), that is (A) beyond the control of the parties to the relevant transaction and (B) associated with a financial, commercial, or economic consequence.

Exemption for Certain Transactions in Exempt Commodities.

Subject to certain conditions, the Act generally exempts transactions in Exempt Commodities from most of the regulatory requirements of the CEA. The Act defines an Exempt Commodity as a commodity that is neither an Excluded Commodity nor an agricultural commodity. Examples of Exempt Commodities include energy and metals commodities. To qualify for this exemption, a transaction in an Exempt Commodity must be entered into (1) between Eligible

⁴Under the CEA, as amended by the Act, the term Trading Facility generally means a person or group of persons that maintains a physical or electronic facility in which multiple persons have the ability to execute transactions by accepting bids and offers made by other participants that are open to multiple participants in the facility, but does not include (1) a facility that permits participants to negotiate bilateral transactions through communications exchanged by such participants (as distinguished from the interaction of multiple bids and offers) or (2) certain activities of government securities dealers and brokers.

⁵The term Electronic Trading Facility is defined in the Act as a Trading Facility that operates by means of an electronic communications network and maintains an automated audit trail of bids, offers and the matching of orders.

Contract Participants and not traded on a Trading Facility or (2) between Eligible Commercial Entities⁶ on a principal-to-principal basis through an Electronic Trading Facility. Qualifying transactions in Exempt Commodities remain subject to a number of provisions of the CEA, including its prohibitions against fraud and manipulation. The Act also authorizes the CFTC to impose certain obligations on Electronic Trading Facilities through which qualifying transactions in Exempt Commodities are conducted.

Additional Exclusions for Certain Hybrid Instruments, Swaps and Certain Banking Products

Hybrid Instruments. The Act provides that the CEA does not apply to a Hybrid Instrument⁷ that is “predominantly a security or depository instrument.” A Hybrid Instrument is deemed to be predominantly a security or depository instrument if:

- (a) the issuer of the instrument receives payment in full of the purchase price at the time that the instrument is delivered;
- (b) the purchaser is not required to make additional payments;

⁶An Eligible Commercial Entity is defined to include:

- (1) certain Eligible Contract Participants (financial institutions, regulated insurance companies, high net worth businesses and organizations, governmental entities, broker dealers and futures commission merchants) that, in connection with their businesses: (i) have the ability to make or take delivery of the underlying commodity, (ii) incur risks, in addition to price risk, related to the commodity, or (iii) are dealers that provide risk management or hedging services or market making activities with respect to the commodity or derivative transactions in the commodity;
- (2) any Eligible Contract Participant, other than a natural person or any State or local governmental entity, that: (i) regularly enters into transactions to purchase or sell the commodity or derivative transactions in the commodity, and (ii) controls assets of \$100 million or more, except for certain specified collective investment vehicles (which must control assets of \$1 billion or more); or
- (3) such other persons as the CFTC shall determine are appropriate.

⁷Under the CEA, as amended by the Act, the term Hybrid Instrument generally is defined as a security or depository instrument that has one or more payments indexed to the value, level or rate of one or more commodities. The CEA broadly defines the term “commodity” to include traditional agricultural commodities such as wheat, cotton, and rice, as well as “all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.” As the Futures Industry Association has noted, “financial instruments, i.e., interest rates, currencies and stock indices, are now the principal ‘commodities’ underlying commodity futures and options regulated under the [CEA].”

- (c) the issuer of the instrument is not subject to mark-to-market margining requirements (for this purpose, mark-to-market margining requirements do not include the obligation of an issuer of a secured debt instrument to increase the amount of collateral for the instrument); and
- (d) the instrument is not marketed as a futures contract.

This “predominance” test is much less complicated than the one previously applied under the CFTC rules.

Swap Transactions. The Act excludes from the reach of the CEA any Swap Transaction, broadly defined as any agreement, contract or transaction in a non-agricultural commodity if it is entered into between Eligible Contract Participants and its terms are subject to individual negotiation and not specified by the terms of a Trading Facility. The Act also directs the CFTC, the Federal Reserve, the Treasury Department and the SEC to conduct a study of the issues relating to the offering of swaps on a retail basis (i.e., to non-Eligible Contract Participants) and to report back to Congress within one year regarding these issues.

Delineation of SEC Authority over Swaps. The Act adds a broad definition of “swap agreement” to the Gramm-Leach-Bliley Act. To qualify under this definition, swap agreements must be entered into by Eligible Contract Participants and all material terms (other than price and quantity) must be individually negotiated. Expressly excluded from this definition are, among other things, options and forwards on securities or security indices. Swap agreements are further bifurcated between “security-based swap agreements” and “non-security-based swap agreements.” The Securities Act is amended to exclude all swap agreements from the definition of “security” thereunder, but to subject security-based swap agreements to the anti-fraud and anti-manipulation provisions of the Securities Act. Similar amendments are made to the Exchange Act, and in addition, security-based swap agreements are made subject to the insider trading and material nonpublic information provisions of the Exchange Act.

Certain Banking Products. The Act excludes Identified Banking Products⁸ from the CEA if the product was commonly offered by a bank on or before December 5, 2000 and was not prohibited by the

⁸Identified Banking Product means (1) any deposit instrument issued by a bank, including savings accounts and certificates of deposit, (2) a banker’s acceptance, (3) a loan made or letter of credit issued by a bank, (4) a debit account at a bank arising from a credit card or similar arrangement, or (5) any loan participation that is sold to qualified investors or other persons that have

CEA or regulated by the CFTC on or before December 5, 2000. If the Identified Banking Product has not been commonly offered on or before December 5, 2000, then the product will be excluded from the CEA if the product (1) is otherwise excluded from the CEA, and (2) has no payment indexed to the value of, and does not provide for the delivery of, any commodity.

Hybrid Instruments that are predominantly banking products (“Bank Hybrid Instruments”) also are not subject to the CEA and CFTC jurisdiction. If the CFTC believes a Bank Hybrid Instrument is not predominantly a banking product, it may consult with the Federal Reserve Board, which in turn may seek judicial review of the legality of the product. The Act also excludes Covered Swap Agreements⁹ from the CEA.

Reform of the Shad–Johnson Accord

Title II of the Act amends the Shad–Johnson Accord by granting to the SEC and the CFTC joint jurisdiction over futures on single stocks and narrow–based stock indices (collectively, “Security Futures”). Broad–based indices remain exclusively under the CFTC’s jurisdiction. The CFTC continues as the primary regulator of futures markets and futures commission merchants, while the SEC remains the primary regulator of securities markets and broker–dealers. To trade Security Futures, futures exchanges and futures commission merchants are required to file notice registrations with the SEC, and securities exchanges and broker–dealers are required to file notice registrations with the CFTC. All exchanges and intermediaries that trade Security Futures will be regulated by both the SEC and CFTC, but only core provisions of each agency’s regulatory regime will apply to the other agency’s regular registrants. To avoid duplicative and inconsistent regulation, the SEC is required to coordinate with the CFTC on examinations of SEC no-

the opportunity and capability, based on generally applicable banking standards or guidelines, to evaluate any material information pertaining to the loan, including information regarding the borrower’s creditworthiness.

⁹Under the CEA, as amended by the Act, the term Covered Swap Agreement generally means any swap agreement, including a credit or equity swap, that either (1) involves a non–agricultural commodity, is entered into between Eligible Contract Participants and is not traded on a Trading Facility, or (2) involves an Excluded Commodity and is traded on a principal–to–principal basis between Eligible Contract Participants on an Electronic Trading Facility.

tice-registered exchanges and broker-dealers, and the CFTC is required to coordinate with the SEC on examinations of CFTC notice-registered markets and intermediaries.

Contract Markets, Derivatives Transaction Execution Facilities and Exempt Boards of Trade

Contract Markets. The Act replaces existing sections 5 and 5a of the CEA with a new section 5, which specifies the criteria to be met by a board of trade in order to be designated as a Contract Market.¹⁰ Contract Markets in existence as of the date of enactment of the Act are grandfathered, and need not meet these criteria. The criteria include:

- (a) establishing and enforcing rules preventing market manipulation;
- (b) ensuring fair and equitable trading;
- (c) specifying how the trade execution facility operates, including any electronic matching systems;
- (d) ensuring the financial integrity of transactions;
- (e) disciplining members or market participants who violate the rules; (f) allowing for public access to the board of trade rules; and
- (g) enabling the board of trade to obtain information in order to enforce its rules.

In addition, the Act provides eighteen core principles that must be met to maintain designation as a Contract Market.

Derivatives Transaction Execution Facilities. The Act amends the CEA to create a new, more flexible designation category for a board of trade—the Derivatives Transaction Exemption Facility or “DTEF.” A board of trade may elect to operate as a DTEF rather than a Contract Market if it meets the DTEF designation requirements, which include:

- (a) establishing and enforcing trading rules that will deter abuses, provide market participants with impartial access to the markets and capture information that may be used in rule enforcement;
- (b) defining trading procedures to be used; and
- (c) providing for the financial integrity of DTEF transactions.

A registered DTEF may trade futures and options on any commodity which has a nearly inexhaustible supply, is not susceptible to manipulation, or does not have a cash market in commercial practice. In general, eligible DTEF traders include Eligible Contract

¹⁰Members of the public may engage in futures transactions on Contract Markets through a registered futures commission merchant.

Participants and persons trading through registered futures commission merchants with capital of at least \$20 million that are members of a self-regulatory organization and a clearing organization. Boards of trade that have been designated as Contract Markets may also operate DTEFs if they provide a separate location for DTEF trading or, in the case of an electronic system, identify whether the trading is on a DTEF or Contract Market. A board of trade must comply with nine core principals to maintain registration as a DTEF. A DTEF also may trade futures and options on futures on any non-agricultural commodity if it limits such trading to Eligible Commercial Participants.

Exempt Boards of Trade. The Act also amends the CEA to permit a board of trade to operate as an Exempt Board of Trade. To qualify as an Exempt Board of Trade, a board of trade must limit trading to contracts with respect to which:

- (a) the underlying commodity either has an inexhaustible deliverable supply, is not subject to manipulation, or has no cash market;
- (b) participants are Eligible Contract Participants; and
- (c) the contracts do not involve securities (including security indices).

Futures contracts traded on an Exempt Board of Trade will continue to be subject to the anti-fraud and anti-manipulation provisions of the CEA. In addition, if the CFTC finds that an Exempt Board of Trade is a significant source of price discovery for the underlying commodity, the Exempt Board or Trade will be required to publicly disseminate trading data appropriate to the market on a daily basis.

Additional Provisions

Contract Enforcement. The Act provides that a transaction between Eligible Contract Participants (or persons reasonably believed to be Eligible Contract Participants) shall not be unenforceable under federal or state law based solely on the failure of the transaction to comply with the terms of an exemption or exclusion provided for under the CEA or by the CFTC. The Act also provides that no Bank Hybrid Instrument or Covered Swap Agreement shall be unenforceable based solely on the failure to comply with the terms or conditions of an exclusion from the CEA.

Excluded Electronic Trading Facilities. The Act excludes Electronic Trading Facilities from regulation under the CEA to the extent they offer facilities for the trading of qualifying transactions in Excluded Commodities (as discussed in Specified Commodities, Excluded Commodities and Exempt Commodities, above) and/or

qualifying Hybrid Instruments and Swap Transactions (as discussed in Additional Exclusions for Certain Hybrid Instruments, Swaps and Certain Banking Products, above).

Preemption. The Act amends the CEA to preempt state bucket shop and gambling laws to the extent they otherwise would apply to: (1) qualifying transactions in Specified Commodities and Excluded Commodities (as discussed in Specified Commodities, Excluded Commodities and Exempt Commodities, above), (2) qualifying Hybrid Instruments, Swap Transactions, Bank Hybrid Instruments and Covered Swap Agreements (as discussed in Additional Exclusions for Certain Hybrid Instruments, Swaps and Certain Banking Products, above), and (3) Excluded Electronic Trading Facilities.

Investment Advisers. The Act amends Section 4m of the CEA to exempt an investment adviser registered under the Investment Advisers Act of 1940 from the requirement to register as a commodity trading advisor under the CEA, where (1) its business does not consist primarily of acting as a commodity trading advisor, and (2) it does not act as a commodity trading advisor to any investment trust or fund that is engaged primarily in trading futures contracts on Contract Markets or DTEFs. This provision appears to expand substantially the ability of registered investment advisors to dispense commodity trading advice without having to register as commodity trading advisors under the CEA.

Derivatives Clearing Organizations. The Act amends the Federal banking laws, the Bankruptcy Code and the CEA to provide a clear statutory basis for the regulation of clearing systems that develop for OTC derivatives.

Effective Date. The provisions of the Act take effect on the date of enactment. Under the Act, trading in Security Futures is prohibited until the later of (1) one year after the date of enactment of the Act, or (2) the date on which a futures association has met the requirements to become a limited purpose national securities association under Section 15A of the Exchange Act. In the case of Eligible Contract Participants trading on a principal-to-principal basis, the one year period described above is reduced to eight months.

Summary

Through its amendments to the CEA, the Act provides much

needed and reasonably flexible standards for identifying those transactions in Specified Commodities, Excluded Commodities and Exempt Commodities, and those Hybrid Instruments and Swap Transactions that are not subject to regulation under the CEA as futures contracts. The Act also removes the bar that has existed, at least since the Shad–Johnson Accord in 1982, to the trading of futures contracts on single stocks and narrowly based stock indices. Moreover, it does so in a way that should give futures exchanges and stock exchanges equal access to such products under the joint regulatory jurisdiction of the CFTC and the SEC. It remains to be seen, however, how smoothly the two agencies will be able to exercise this joint authority. Finally, through the amendments to the Contract Market provisions of the CEA and the addition of the DTEF and Exempt Board of Trade provisions, the Act has greatly simplified and modernized the process for designating boards of trade that can offer futures contracts.