January 29, 1997

Draft

The Honorable Richard G. Lugar
Chairman
Committee on Agriculture,
Nutrition and Forestry
United States Senate
Washington, D.C. 20515

Dear Chairman Lugar:

The staffs of the Commodity Futures Trading Commission and the Treasury Department have met over the past thirteen months to discuss the policy underlying the provision of the Commodity Exchange Act (CEA) commonly referred to as the "Treasury Amendment." Both agencies agree on the need to clarify the scope of the CFTC's authority to protect retail customers against fraud by entities that are not currently subject to any federal regulation or supervision. Unfortunately, Treasury and the CFTC have been unable to reach agreement on the proper approach for achieving this goal and continue to disagree on several key issues. During that time, we have also worked to protect the interests of the Department in litigation, including the Dunn case before the Supreme Court. This letter will not restate the legal arguments put forward in that context which are still valid today.

The CFTC recently transmitted to you a proposal for changes to the Treasury Amendment. Treasury objects to the proposal that the CFTC has offered. Enclosed for your consideration is a Treasury proposal to amend the Treasury Amendment in a way that addresses the retail fraud issue in a clear and direct manner without creating new ambiguities or unnecessarily increasing the regulatory burden of entities already subject to federal regulation.

One of the key points of difference between Treasury and the CFTC relates to the treatment of the over-the-counter institutional market for foreign exchange and the other instruments enumerated in the Treasury Amendment. Treasury believes this market should be entirely exempt from the CEA, as it is under the current Treasury Amendment. The public is well served by deep and liquid foreign exchange markets which provide access to foreign exchange instruments for a wide range of

U.S. businesses that need to participate in global commerce. Although the CFTC acknowledges that it agrees with Treasury that the "interbank market [should] remain exempt from regulation under the CEA," the draft legislation proposed by the CFTC does not provide an unambiguous exemption for all segments of the over-the-counter institutional markets. If enacted, the CFTC's legislation would likely result in additional litigation concerning the scope of exempted activities. Continued uncertainty would have a harmful effect on these important markets and may cause such markets to move overseas. Treasury understands that the staffs of the bank regulatory agencies and the Securities and Exchange Commission share its concern about the potentially harmful impact of continued uncertainty in the institutional markets.

Treasury is also concerned that the CFTC's proposal imposes an unwarranted overlay of CFTC jurisdiction on federally regulated entities, such as banks, that may sell Treasury Amendment instruments to small businesses or members of the general public. There is no evidence that existing regulatory structures fail to ensure that there is adequate federal oversight of such transactions. Moreover, we believe that it is unwise to impose additional layers of regulation upon entities that are already under the jurisdiction of one or more federal regulators.

Thank you for your consideration of Treasury's proposal. We continue to discuss these issues with the CFTC and anticipate discussing our proposal with the federal banking agencies and the SEC. We look forward to working with you and your staff.

Sincerely,

Robert E. Rubin

Treasury Legislative Proposal to Amend the Treasury Amendment

Background

Under the CEA, the CFTC generally is given jurisdiction over contracts for the sale of commodities for future delivery (commonly referred to as futures contracts) and options on commodities. Before 1974, the term "commodity" in the CEA included only tangible agricultural commodities. In 1974, when the CFTC was created, the definition of the term "commodity" was significantly expanded. The new definition was open-ended, encompassing "all services, rights and interests in which contracts for future delivery are presently or in the future dealt in." The concepts of "futures contracts" and "options" remained undefined. The Treasury Department proposed language exempting off-exchange derivative transactions in foreign currency, government securities, and certain other financial instruments from the newly expanded CEA. This exemption was adopted virtually unchanged by Congress and is known as the Treasury Amendment.

In proposing the amendment, Treasury's primary concern was to protect the foreign currency market in the United States from potentially harmful regulation. In a letter to the Chairman of the Senate Committee on Agriculture and Forestry, Treasury noted that the foreign currency market "has proved highly efficient in serving the needs of international business in hedging the risks that stem from foreign exchange rate movements." S. Rep. No. 1131, 93rd Cong., 2d Sess. 50 (1974). Since that market consisted primarily of banks and dealers, Treasury believed that it would be inappropriate for any additional regulation of this complex function to be carried out by the CFTC. Treasury argued that granting the CFTC jurisdiction over the foreign currency market would confuse an already highly regulated business sector and that new regulatory limitations and restrictions could have an adverse impact on the usefulness and efficiency of foreign exchange markets for traders and investors. For similar reasons, Treasury argued that the CEA should exempt derivative transactions involving government securities and a variety of other financial instruments, unless conducted on organized exchanges.

Since the enactment of the Treasury Amendment, the size and importance of the markets for both foreign currency and government securities have increased dramatically. As a result, the goal of the Treasury Amendment, to preserve the efficiency of these markets by avoiding unnecessary regulation and uncertainty, is even more compelling today. Indeed, when it enacted the Government Securities Act of 1986, Congress recognized that unnecessary or inflexible regulation could increase the government's borrowing costs, and it acknowledged the need to preserve both the efficiency and the integrity of that market. S. Rep. No. 1416, 99th Cong., 1st Sess. 10 (1985).

Given this dramatic growth in the size of the financial markets since 1974, the open-ended nature of CEA coverage makes it even more crucial that the scope of the exemption from the CEA be absolutely clear. However, since the Treasury Amendment's enactment, the scope of CEA coverage has continued to be a troublesome source of legal uncertainty for the financial markets. Determining how to draw the line between instruments that are subject to the CEA and those that are not, in a manner that provides logical consistency and predictability for new instruments, has been difficult under current law.

In the mid-1980's, a greater focus on these issues resulted from various interpretive and rule-making activities of the CFTC. In the CFTC's view, the concepts of "futures contracts" and "options," particularly when applied to transactions involving non-agricultural commodities, were potentially very far-reaching. For example, under the CFTC's Hybrid Instruments Rule, 17 C.F.R. pt. 34, the CFTC has asserted jurisdiction over certain securities and bank deposits whose value is linked to the price of commodities, unless such instruments meet certain criteria for exemption set forth in the Rule. Instruments such as bonds linked to the price of foreign currency and certain types of deposits of foreign currency in U.S. bank accounts may potentially be viewed by the CFTC as commodity futures or options subject to CEA regulation.

Recently, the CFTC has brought a number of enforcement actions asserting jurisdiction over foreign currency derivative transactions that have created significant interpretative issues about the scope of the Treasury Amendment. The CFTC's goal in bringing these enforcement actions -- the protection of unsophisticated investors from the unsavory or fraudulent practices of bucket shops or other unregulated entities -- is an important one, as Treasury has long acknowledged.[1] Unfortunately, the ambiguity created by these enforcement actions has significantly diminished the efficacy of the Treasury Amendment in providing a bright-line exclusion from the CEA for the markets in the enumerated financial instruments. Treasury does not believe that it would be good public policy to solve a discrete enforcement problem in a way that generates legal uncertainty throughout enormously important financial markets.

The CEA's language strongly tends to favor exchange trading, a mode of conducting transactions that developed in connection with agricultural commodities. Various financial futures and options have developed in that environment so successfully that the volume of financial futures and options on the various commodities exchanges, measured in terms of notional value of transactions, far exceeds that of agricultural commodities. However, there is a fundamental question whether that mode of conducting transactions is appropriate for all transactions involving financial instruments that, in the view of the CFTC, may constitute futures contracts or options. The financial markets have provided their own answer to this question: the notional amount of foreign exchange futures contracts traded over-the-counter is several orders of magnitude greater than that traded on exchanges.

The CFTC has some flexibility to address this fundamental question through the general exemptive authority granted to it by Congress in 1992. However, Treasury does not believe that reliance on this exemptive authority will provide the needed level of certainty for the foreign currency and government securities markets. One concern is that reliance on the exemptive authority could be interpreted as an implicit conclusion that the exempted transactions in question are futures or options subject to CFTC jurisdiction. Thus, reliance on exemptive authority requires market participants to operate, as a matter of caution, as if the transactions at issue <u>are</u> futures or options and structure their transactions to qualify for the regulatory exemption. If the CFTC later decides to change the parameters of the exemption, market participants would be forced to restructure their transactions accordingly or fall back on the position that the transactions are not, in fact, futures or options subject to the CEA, with all the accompanying legal uncertainty.

<u>Treasury Proposal</u>

In drafting the attached proposal, Treasury was guided by the principle that the appropriate legal standard should provide adequate protection of retail participants while achieving maximum legal certainty for the derivative markets in foreign currency and government securities, as well as the other enumerated financial instruments. Our proposal is structured to provide a broad exemption from the CEA for these transactions without resorting to terms that are undefined, open-ended, or both. Instead, we have attempted to draw the relevant lines by reference to objective factors that can be determined by all interested parties, including market participants. Although we have not expanded the list of covered instruments, we believe consideration must be given to whether the list should be updated and expanded to reflect some of the expansion in the variety of financial instruments since 1974, and the significance of certain products to investors. Recognizing that the resolution of certain issues raised by Treasury's proposal may require us to modify our approach, we would welcome the opportunity to continue to work with the Committee, as necessary, to expand the list of covered instruments, and to resolve other matters raised by our proposal.

1. <u>Exemption for Government Securities Transactions</u>.

Treasury's proposal is structured to provide a complete exclusion for transactions in, or in any way involving, government securities unless those transactions are conducted on an organized exchange. Certain other securities transactions currently sheltered by the Treasury Amendment are similarly excluded. Treasury shares the CFTC's concern that the law should not provide a loophole for unregulated entities to defraud retail investors. With respect to these transactions, however, the federal securities laws serve that purpose. Indeed, the government securities market itself is now subject to a regulatory regime that did not exist at the time the Treasury Amendment was adopted. The proposal retains similar treatment for resales of installment loan contracts, mortgages, and mortgage purchase commitments.

So SEC could regulate? (instead of CFTC)?

Also subject to federal securities laws?

The CFTC's proposal, by contrast, would subject entire classes of transactions involving government securities (and other Treasury Amendment instruments) to an additional regulatory scheme that may or may not be consistent with existing law. In particular, the CFTC's draft makes reference to the "when issued" government securities market, in which investors enter into contracts for the purchase of government securities to be issued at a later date. This market is of vital importance to the liquidity of the government securities market and helps to reduce the cost of government borrowing. Treasury believes this market is currently appropriately regulated and that CFTC regulation, or the threat of such regulation, of this market could be detrimental to government finance. Although CFTC staff has stated its belief that the "when issued" market is a "cash" market that is not, and should not be, the subject of CFTC regulation, the draft legislation prepared by the CFTC does not clearly exempt this market from CFTC regulation.

? would like this in CFTC text?

2. Exemption for Foreign Currency Transactions.

A. Transactions between Unregulated Entities and Retail Customers.

Treasury's proposal would permit the CFTC to regulate transactions involving foreign currency that are conducted on an organized exchange. It would also confer antifraud authority over foreign currency transactions conducted between any unregulated person and a retail customer. The term "unregulated person" is defined as a person who is not currently regulated by one of the federal bank regulators or is not a broker-dealer or investment company regulated by the Securities and Exchange Commission. A "retail customer" is defined in terms of net worth and income, to include any natural person other than a natural person with a net worth above $1,000,000 or with an annual income of more than $200,000 (or $300,000 when combined with one's spouse). This definition is drawn from the SEC's definition in Regulation D, 17 C.F.R. § 230.501, which delineates a class of sophisticated investors for whom the full protections of federal securities regulation are deemed unnecessary.[2] Drawing the line in this fashion clearly permits the CFTC to take regulatory or enforcement actions in the area where needed[3] while preserving the legal certainty originally intended by the Treasury Amendment.

B. Transactions between Regulated Entities and Retail Customers.

Treasury perceives no need for CFTC regulation of transactions involving regulated entities, such as banks and broker-dealers, that may sell foreign currency instruments to small businesses or individuals that do not meet certain net worth or income thresholds. Such customers may have legitimate risk-management needs for specialized instruments that are not available on exchanges, such as futures contracts on particular foreign currencies. The extent of such transactions is extremely limited at present, probably due in part to the uncertain legal environment surrounding such transactions. Granting the CFTC regulatory authority over such transactions could mean that they do not occur, since the CEA is based on the presumption that most non-exchange derivative transactions should be illegal, unless demonstrated otherwise. We believe, however, that regulation of this nature is unwarranted where the entities involved are already subject to extensive schemes of federal regulation. Such entities should not be constrained from meeting the needs of their customers.

Does the Fed/OCC have regs on this?

No explicit power to regulate this, but falls under safety & soundness

Handled via examination or policy statements

C. The Institutional Markets.

Finally, Treasury believes that it is neither necessary nor appropriate to expand the scope of the CFTC's jurisdiction to regulate any segment of the institutional markets. Thus, we believe that transactions engaged in by persons other than retail customers -- including, but not limited to, banks, broker-dealers, corporations, and individuals whose net worth or income takes them outside of the definition of retail customer -- should not be subject to regulation under the CEA. Institutional participants, whether currently regulated or not, have the sophistication and the financial means to protect themselves and to handle their disputes without the assistance of the CFTC. As noted, the limited number of enforcement actions the CFTC has brought over the years have been in the context of bucket shops dealing with unsophisticated retail customers. ?

Creating a more restrictive or legally uncertain regulatory environment could detrimentally affect the institutional market, causing the foreign currency market to migrate overseas to a more favorable environment. Migration of the foreign currency futures and options market could have a spillover effect on that market, resulting in restricted access to these markets for many participants. The United States foreign currency market is too large and too important to be subjected to unnecessary regulation or the vagaries of case law created in the context of retail enforcement actions.

We note that the CFTC's draft legislation provides that transactions in "defined financial instruments" entered into by "appropriate persons" are entirely exempt from the CEA if the conduct of the persons is "subject to provisions of civil federal law prohibiting fraud and price manipulation other than the [CEA]." It appears that this provision is designed to exempt transactions between banks, broker-dealers,

— would this be true of nonfin corporations and other regulated entities from the provisions of the CEA, a goal shared by Treasury. The law would be greatly clarified, however, if the categories of exempted entities were listed, as they are in Treasury's proposal, rather than leaving the question of coverage open to interpretation by the CFTC and/or the courts. Moreover, the CFTC's proposal does not clearly establish whether all, or only some, of the "appropriate persons" in a given transaction must be subject to other federal laws before the exemption from the CEA would be available. Thus, the proposal does not provide a clear exemption for other sophisticated institutional market participants, such as corporations and high-net worth individuals, that are not directly subject to federal regulation. Yes, not clear.

3. <u>Definition of "Organized Exchange"</u>

Under the existing Treasury Amendment, the CFTC retains jurisdiction to regulate certain transactions in Treasury Amendment instruments that occur on a "board of trade." The use of this term, however, has given rise to many of the interpretive difficulties that exist under current law. Treasury's proposal allows continued CFTC jurisdiction over transactions occurring on an "organized exchange" and supplies a detailed definition of this new term. The definition clarifies that entities engaged in the business of buying or selling Treasury Amendment instruments, such as banks, broker-dealers, futures commission merchants, and government securities dealers and brokers, will not be deemed to be organized exchanges; rather, the definition includes entities that serve as a marketplace for arms' length transactions. Moreover, an entity will not be deemed an organized exchange if it is not open to transactions for the account of retail customers. Thus, the definition would allow the continued development of unregulated markets that serve the needs of institutional customers. ok