that this proposal would not have sufficient federalism implications to warrant the preparation of a Federalism Assessment.

For the reasons discussed above, I certify that this proposed regulation (1) is not a ''significant regulatory action'' under Executive Order 12866; (2) is not a ''significant rule'' under the DOT Regulatory Policies and Procedures (44 FR 11034, February 26, 1979); and (3) if promulgated, will not have a significant economic impact, positive or negative, on a substantial number of small entities under the criteria of the Regulatory Flexibility Act. A copy of the draft regulatory evaluation prepared for this action is contained in the Rules Docket. A copy of it may be obtained by contacting the Rules Docket at the location provided under the caption **ADDRESSES.**

List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Safety.

The Proposed Amendment

Accordingly, pursuant to the authority delegated to me by the Administrator, the Federal Aviation Administration proposes to amend part 39 of the Federal Aviation Regulations (14 CFR part 39) as follows:

PART 39—AIRWORTHINESS DIRECTIVES

1. The authority citation for part 39 continues to read as follows:

Authority: 49 U.S.C. 106(g), 40113, 44701.

§ 39.13 [Amended]

2. Section 39.13 is amended by adding the following new airworthiness directive:

Dornier Luftfahrt GMBH: Docket 98–NM–123–AD.

Applicability: Model 328–100 series airplanes, equipped with nose landing gear (NLG) having serial below IL113; certificated in any category.

Note 1: This AD applies to each airplane identified in the preceding applicability provision, regardless of whether it has been modified, altered, or repaired in the area subject to the requirements of this AD. For airplanes that have been modified, altered, or repaired so that the performance of the requirements of this AD is affected, the owner/operator must request approval for an alternative method of compliance in accordance with paragraph (b) of this AD. The request should include an assessment of the effect of the modification, alteration, or repair on the unsafe condition addressed by this AD; and, if the unsafe condition has not been eliminated, the request should include specific proposed actions to address it.

Compliance: Required as indicated, unless accomplished previously.

To correct cracking in the axle adapter of the shock absorber of the NLG, which could cause failure of the NLG and consequent damage to the airplane structure, accomplish the following:

(a) Within 300 flight hours after the effective date of this AD, perform a one-time visual inspection to detect cracking in the axle adapter of the NLG shock absorber, in accordance with Dornier Service Bulletin SB–328–32–213, dated April 16, 1997.

(1) If no cracking is detected, no further action is required by this AD.

(2) If any cracking is detected, prior to further flight, remove the NLG shock absorber and replace with a new or serviceable part, in accordance with the service bulletin.

Note 2: Dornier Service Bulletin SB–328–32–213, dated April 16, 1997, references Messier-Dowty Service Bulletin 800–32–027, dated May 7, 1997, as an additional source of service information to accomplish the inspection, removal, and repair.

(b) An alternative method of compliance or adjustment of the compliance time that provides an acceptable level of safety may be used if approved by the Manager, International Branch, ANM–116, FAA, Transport Airplane Directorate. Operators shall submit their request through an appropriate FAA Principal Maintenance Inspector, who may add comments and then send it to the Manager, International Branch, ANM–116.

Note 3: Information concerning the existence of approved alternative methods of compliance with this AD, if any, may be obtained from the International Branch, ANM–116.

(c) Special flight permits may be issued in accordance with sections 21.197 and 21.199 of the Federal Aviation Regulations (14 CFR 21.197 and 21.199) to operate the airplane to a location where the requirements of this AD can be accomplished.

Note 4: The subject of this AD is addressed in German airworthiness directive 97–142, dated May 22, 1997.

Issued in Renton, Washington, on May 5, 1998.

John J. Hickey,

Acting Manager, Transport Airplane Directorate, Aircraft Certification Service.

[FR Doc. 98–12510 Filed 5–11–98; 8:45 am]

BILLING CODE 4910–13–U

COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 34 and 35

Over-the-Counter Derivatives

AGENCY: Commodity Futures Trading Commission.

ACTION: Concept Release.

SUMMARY: The Commodity Futures Trading Commission (''CFTC'' or ''Commission'') has been engaged in a comprehensive regulatory reform effort designed to update the agency's oversight of both exchange and off-exchange markets. As part of this reform effort, the Commission is reexamining its approach to the over-the-counter (''OTC'') derivatives market.

OTC derivatives are contracts executed outside of the regulated exchange environment whose value depends on (or derives from) the value of an underlying asset, reference rate, or index. They are used by market participants to perform a wide variety of important risk management functions. The CFTC's last major regulatory actions involving OTC derivatives were regulatory exemptions for certain swaps and hybrid instruments adopted in January 1993. Since that time, the OTC derivatives market has grown dramatically in both volume and variety of products offered and has attracted many new end-users of varying degrees of sophistication. The market has also changed, with new products being developed, with some products becoming more standardized, and with systems for central execution or clearing being studied or proposed.

The Commission hopes that the public comments filed in response to this release will constitute an important source of relevant data and analysis that will assist it in determining whether its current regulatory approach continues to be appropriate or requires modification. The Commission wishes to maintain adequate safeguards without impairing the ability of the OTC derivatives market to continue to grow and the ability of U.S. entities to remain competitive in the global financial marketplace. The Commission has identified a broad range of issues and potential approaches in order to generate detailed analysis from commenters. The Commission urges commenters to analyze the benefits and burdens of any potential regulatory modifications in light of current market realities. The Commission has no preconceived result in mind. The Commission is open both to evidence in support of easing current restrictions and evidence indicating a need for additional safeguards. The Commission also welcomes comment on the extent to which certain matters are being or can be adequately addressed through self-regulation, either alone or in conjunction with some level of government oversight, or through the regulatory efforts of other government agencies.

New regulatory restrictions ultimately adopted, if any, will be adopted only after publication for additional public comment and will be applied prospectively only. This release in no

way alters the current status of any instrument or transaction under the Commodity Exchange Act. All currently applicable exemptions, interpretations, and policy statements issued by the Commission regarding OTC derivatives products remain in effect, and market participants may continue to rely upon them.

DATES: Comments must be received on or before July 13, 1998.

ADDRESSES: Comments should be mailed to Jean A. Webb, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, D.C. 20581; transmitted by facsimile to (202) 418–5521; or transmitted electronically to {secretary@cftc.gov}. Reference should be made to ''Over-the-Counter Derivatives Concept Release.''

FOR FURTHER INFORMATION CONTACT: I. Michael Greenberger, Director, David M. Battan, Special Counsel, or John C. Lawton, Associate Director, Division of Trading and Markets, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street N.W., Washington, D.C. 20581 (202) 418–5430.

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I. Introduction

A. Description of Over-the-Counter Products and Markets

Over-the-counter (OTC) derivatives are contracts executed outside of the regulated exchange environment whose value depends on (or derives from) the value of an underlying asset, reference rate or index.[1] The classes of underlying assets from which a derivative instrument may derive its value include physical commodities (*e.g.*, agricultural products, metals, or petroleum), financial instruments (*e.g.*, debt and interest rate instruments or equity securities), indexes (*e.g.*, based on interest rates or securities prices), foreign currencies, or spreads between the value of such assets.

Like exchange-traded futures and option contracts, OTC derivatives are used to perform a wide variety of important risk management functions. End-users employ OTC derivatives to address risks from volatility in interest rates, foreign exchange rates, commodity prices, and equity prices, among other things. OTC derivative instruments also can be used to assume price risk in order to increase investment yields or to speculate on price changes. Participants in the OTC derivatives market include banks, other financial service providers, commercial corporations, insurance companies, pension funds, colleges and universities, and governmental entities.

Use of OTC derivatives has grown at very substantial rates over the past few years. According to the most recent market survey by the International Swaps and Derivatives Association (''ISDA''), the notional value of new transactions reported by ISDA members in interest rate swaps, currency swaps, and interest rate options during the first half of 1997 increased 46% over the previous six-month period.[2] The notional value of outstanding contracts in these instruments was $28.733 trillion, up 12.9% from year-end 1996, 62.2% from year-end 1995, and 154.2% from year-end 1994.[3] ISDA's 1996 market survey noted that there were 633,316 outstanding contracts in these instruments as of year-end 1996, up 47% from year-end 1995, which in turn represented a 40.7% increase over year-end 1994.[4] An October 1997 report by the General Accounting Office (''GAO'') suggests that the market value of those OTC derivatives represents ''about 3 percent'' of the notional amount.[5] Applying the 3% figure to the most recent ISDA number for contracts outstanding for the first half of 1997 indicates that the world-end market value of these OTC derivatives transactions is over $860 billion.

While OTC derivatives serve important economic functions, these products, like any complex financial instrument, can present significant risks if misused or misunderstood by market participants. A number of large, well publicized, financial losses over the last few years have focused the attention of the financial services industry, its regulators, derivatives end-users, and the general public on potential problems and abuses in the OTC derivatives market.[6] Many of these losses have come to light since the last major regulatory actions by the CFTC involving OTC derivatives, the swaps and hybrid instruments exemptions issued in January 1993.[7]

B. Purpose of This Release

The Commission has been engaged in a comprehensive regulatory reform effort designed to update the agency's oversight of both exchange and off-exchange markets.[8] As part of this process, the Commission believes that it is appropriate to reexamine its regulatory approach to the OTC derivatives market taking into account developments since 1993. The purpose

[1] See Group of Thirty, *Derivatives: Practices and Principles* 2 (1993).

[2] International Swaps and Derivatives Association, Summary of Recent Market Survey Results, ISDA Market Survey, available at (http://www.isda.org).

[3] Id.

[4] Id.

[5] General Accounting Office, GAO/GGD–98–5, OTC Derivatives: Additional Oversight Could Reduce Costly Sales Practice Disputes 3 n.6 (1997) [hereinafter ''1997 GAO Report'']. The notional amount represents the amount upon which payments to the parties to a derivatives transaction are based and is the most commonly used measure of outstanding derivatives transactions. Notional amounts generally overstate the amount at risk and the market value of such transactions.

[6] See, e.g., Jerry A. Markham, Commodities Regulation: Fraud, Manipulation & Other Claims, Section 27.05 nn. 2–22.1 (1997) (listing 22 examples of significant losses in financial derivatives transactions); 1997 GAO Report at 4 (stating that the GAO identified 360 substantial end-user losses). Some of these transactions involved instruments that are not subject to the CEA.

[7] Each of these exemptions is discussed in Part II, below.

[8] See, e.g., Proposed Rulemaking Permitting Future-Style Margining of Commodity Options, 62 FR 66569 (Dec. 19, 1997); Concept Release on the Denomination of Customer Funds and the Location of Depositories, 62 FR 67841 (Dec. 30, 1997); Account Identification for Eligible Bunched Orders, 63 FR 695 (Jan. 7, 1998); Maintenance of Minimum Financial Requirements by Futures Commission Merchants and Introducing Brokers, 63 FR 2188 (Jan. 14, 1998); Requests for Exemptive, No-Action and Interpretative Letters, 63 FR 3285 (Jan. 22, 1998); Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market, 63 FR 3708 (Jan. 26, 1998); Distribution of Risk Disclosure Statements by Futures Commission Merchants and Introducing Brokers, 63 FR 8566 (Feb. 20, 1998); Amendments to Minimum Financial Requirements for Futures Commission Merchants, 63 FR 12713 (March 16, 1998); Two-Part Documents for Commodity Pools, 63 FR 15112 (March 30, 1998); and Trade Options on the Enumerated Agricultural Commodities, 63 FR 18821 (April 16, 1998). See also Application of FutureCom, Ltd. as a Contract Market in Live Cattle Futures and Options, 62 FR 62566 (Nov. 24, 1997) (Internet-based trading system); Application of Cantor Financial Futures Exchange as a Contract Market in US Treasury Bond, Ten-Year Note, Five-Year Note and Two-Year Note Futures Contracts, 63 FR 5505 (Feb. 3, 1998) (electronic trading system).

of this release is to solicit comments on whether the regulatory structure applicable to OTC derivatives under the Commission's regulations should be modified in any way in light of recent developments in the marketplace and to generate information and data to assist the Commission in assessing this issue.

The market has continued to grow and to evolve in the past five years. As indicated above, volume has increased dramatically. New end-users of varying levels of sophistication have begun to participate in this market. Products have proliferated, with some products becoming increasingly standardized. Systems for centralized execution and clearing are being proposed.

The Commission hopes that the public comments filed in response to this release will constitute an important source of relevant data and analysis that will assist it in determining how best to maintain adequate regulatory safeguards without impairing the ability of the OTC derivatives market to continue to grow and the ability of U.S. entities to remain competitive in the global financial marketplace. The Commission has no preconceived result in mind. The Commission wishes to draw on the knowledge and expertise of a broad spectrum of interested parties including OTC derivatives dealers, end-users of derivatives, other regulatory authorities, and academicians. The Commission urges commenters to provide detail on current custom and practice in the OTC derivatives marketplace in order to assist the Commission in gauging the practical effect of current exemptions and potential modifications.

The Commission is open both to evidence in support or broadening its exemptions and to evidence indicating a need for additional safeguards. Serious consideration will be given to the views of all interested parties before regulatory changes, if any, are proposed. In evaluating the comments and ultimately deciding on its course of action, the Commission will, of course, also engage in its own research and analysis. Any proposed changes will be carefully designed to avoid unduly burdensome or duplicative regulation that might adversely affect the continued vitality of the market and will be published for public comment. Moreover, any changes which impose new regulatory obligations or restrictions will be applied prospectively only.

As this process goes forward, the Commission is mindful of the industry's need to retain flexibility in designing new products as well as the need for legal certainty concerning the enforceability of agreements. Therefore, the Commission wishes to emphasize that, as was the case with other recent concept releases, this release identifies a broad range of issues in order to stimulate public discussion and to elicit informed analysis. This release does not in any way alter the current status of any instrument or transaction under the CEA. All currently applicable exemptions, interpretations, and policy statements issued by the Commission regarding OTC derivatives products remain in effect, and market participants may continue to rely upon them.

II. Current Exemptions [9]

A. Swaps

1. Policy Statement

The Policy Statement was adopted by the Commission on July 21, 1989.[10] It provides a safe harbor from regulation by the Commission under the CEA for qualifying agreements. It addresses only swaps settled in cash, with foreign currencies considered to be cash.[11]

To qualify for a safe harbor from regulation under the Policy Statement, a swap agreement must have all of the following characteristics: (1) individually tailored terms; (2) an absence of exchange-style offset; (3) an absence of a clearing organization or margin system; (4) undertaken in conjunction with a line of business; and (5) not marketed to the general public.

These conditions limit the applicability of the Policy Statement primarily to agreements entered into by institutional and commercial entities such as corporations, commercial and investment banks, thrift institutions, insurance companies, governments and government-sponsored or -chartered entities. The Commission indicated however, that the restrictions did not ''preclude dealer transactions in swaps undertaken in conjunction with a line of business, including financial intermediation services.'' [12] Moreover, the restrictions reflect the Commission's understanding that qualifying transactions will be entered into with the expectation of performance by the counterparties, will be bilaterally negotiated as to material economic terms based upon individualized credit determinations, and will be documented by the parties in an agreement (or series of agreements) that is not standardized.[13] The restrictions are not intended to prevent the use of master agreements between two counterparties, provided that the material terms of the master agreement and the transaction specifications are individually tailored by the parties.[14]

2. Part 35

The Futures Trading Practices Act of 1992 (''1992 Act'') [15] added subsections (c) and (d) to section 4 of the Act. Section 4(c)(1) [16] authorizes the Commission, by rule, regulation or order, to exempt any agreement, contract or transaction, or class thereof from the exchange-trading requirements of Section 4(a) or any other requirement of the Act other than Section 2(a)(1)(B). Section 4(c)(2) [17] provides that the Commission may not grant any exemption unless the Commission determines that the transaction will be entered into solely between ''appropriate persons.'' [18] that the exchange trading requirements of Section 4(a) should not be applied, that the agreement, contract or transaction in question will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the Act, and that the exemption would be consistent with the public interest and the purposes of the Act.

The Commission may grant exemptions ''either unconditionally or on stated terms or conditions.'' [19] Thus,

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[9] In addition to the exemptions discussed in the text, the CEA excludes certain transactions. Forward contracts are excluded in section 1a(11) of the CEA, 7 U.S.C. 1A(11). The Treasury Amendment of the CEA excludes ''transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgage and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board or trade.'' Section 2(a)(1)(A)(ii), 7 U.S.C. 2(ii). Furthermore, options on securities or securities indexes are excluded from the Act. Section 2(a)(1)(B)(i), 7 U.S.C. 2a(i). The Commission by order has also exempted certain transactions in energy products from the provisions of the CEA. Exemption for Certain Contracts Involving Energy Products, 58 FR 21286 (April 20, 1993). In addition, the Commission has exempted certain trade options. 17 C.F.R. 32.4; Trade Options on Enumerated Agricultural Commodities, 63 FR 18821 (April 16, 1998). The Commission has also exempted certain transactions in which U.S. customers establish or offset foreign currency options on the Honk Kong Futures Exchange. Petition of the Philadelphia Stock Exchange, Inc. for Exemptive Relief To Permit United States Customers To Establish or Offset Positions in Certain Foreign Currency Options on the Hong Kong Futures Exchange, Ltd. Through Registered Broker-Dealers, 62 FR 15659 (April 2, 1997).

[10] 54 FR 30694 (July 21, 1989).

[11] Id. at 30696.

[12] Id. at 30697.

[13] Id at 30696–97.

[14] See id. at 30696 n. 17.

[15] Pub. L. No. 102–546 (1992), 106 Stat 3590, 3629.

[16] 7 U.S.C. 6(c)(1).

[17] 7 U.S.C. 6(c)(2).

[18] 7 U.S.C. 6(c)(3).

[19] 7 U.S.C. 6(c)(1). Section 4(d), 7 U.S.C. 6(d), provides that

[t]he granting of an exemption under this section shall not affect the authority of the Commission under any other provision of the Act to conduct investigations in order to determine compliance with the requirements or conditions of such exemption or to take enforcement action for any violation of any provision of this Act or any rule, regulation or order thereunder caused by failure to comply with or satisfy such conditions or requirements.

Section 4(c) gives the Commission the authority to tailor its regulatory program to fit the realities of the marketplace and the needs of market participants.

Part 35 of the Commission's regulations exempts swap agreements meeting specified criteria from the provisions of the CEA and the Commission's regulations promulgated thereunder except for the following: Section 2(a)(1)(B) of the CEA; [20] the antifraud provisions set forth in Sections 4b and 4o of the CEA [21] and Commission Rule 32.9; [22] and the antimanipulation provisions set forth in Sections 6(c) and 9(a)(2) of the CEA.[23] The Part 35 swap exemption is retroactive and effective as of October 23, 1974, the date of enactment of the Commodity Futures Trading Commission at of 1974.[24] Part 35 was promulgated under authority granted to the Commission by Section 4(c) of the Act.[25]

To be eligible for exemptive treatment under Part 35, an agreement: (1) must be a swap agreement as defined in Regulation 35.1(b)(1); (2) must be entered into solely between eligible swap participants; (3) must not be a part of a fungible class of agreements that are standardized as to their material economic terms; (4) must include as a material consideration the creditworthiness of a party with an obligation under the agreement; and (5) must not be entered into and traded on or through a multilateral transaction execution facility. These criteria were designed to assure that the exempted swaps agreements met the requirements set forth by Congress in Section 4(c) of the CEA and ''to promote domestic and international market stability, reduce market and liquidity risks in financial markets, including those markets (such as futures exchanges) linked to swap markets and eliminate a potential source of systemic risk.'' [26]

The definition of ''swap agreement'' provided in Regulation 35.1(b)(1) is as follows:

Swap agreement means: (i) An agreement (including terms and conditions incorporated by reference therein) which is a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency option, any other similar agreement (including any option to enter into any of the foregoing); (ii) Any combination of the foregoing; or (iii) A master agreement for any of the foregoing together with all supplements thereto.

This definition is the same as the definition of swap agreement set forth in Section 4(c)(5)(B) of the CEA.[27]

Regulation 35.1(b)(2) defines ''eligible swap participant'' as follows:

(i) A bank or trust company (acting on its own behalf or on behalf of another eligible swap participant);

(ii) A savings association or credit union;

(iii) An insurance company;

(iv) An investment company subject to regulation under the Investment Company Act of 1940 . . . or a foreign person performing a similar role or function subject as such to foreign regulation, provided that such investment company or foreign person is not formed solely for the specific purpose of constituting an eligible swap participant;

(v) A commodity pool formed and operated by a person subject to regulation under the Act or a foreign person performing a similar role or function subject as such to foreign regulation, provided that such commodity pool or foreign person is not formed solely for the specific purpose of constituting an eligible swap participant and has total assets exceeding $5,000,000;

(vi) A corporation, partnership, proprietorship, organization, trust, or other entity not formed solely for the specific purpose of constituting an eligible swap participant (A) which has total assets exceeding $10,000,000; or (B) the obligations of which under the swap agreement are guaranteed or otherwise supported by a letter of credit * * * or other agreement by any such entity referenced in this subsection (vi)(A) * * * or * * * in paragraph (i), (ii), (iii), (iv), (v), (vi) or (viii) of this section; or (C) which has a net worth of $1,000,000 and enters into the swap agreement in connection with * * * its business; or which has a net worth of $1,000,000 and enters into the swap agreement to manage the risk of an asset or liability owned or incurred in the conduct of its business or reasonably likely to be owned or incurred in * * * its business;

(vii) An employee benefit plan subject to the Employee Retirement Income Security Act of 1974 or a foreign person performing a similar role or function subject as such to foreign regulation with total assets exceeding $5,000,000, or whose investment decisions are made by a bank, trust company, insurance company, investment adviser subject to regulation under the Investment Advisers Act of 1940 * * * or a commodity trading advisor subject to regulation under the Act;

(viii) Any governmental entity (including the United States, any state, or any foreign government) or political subdivision thereof, or any multinational or supranational entity or any instrumentality, agency, or department of any of the foregoing;

(ix) A broker-dealer subject to regulation under the Securities Exchange Act of 1934 * * * or a foreign person performing a similar role or function subject as such to foreign regulation, acting on its own behalf or on the behalf of another eligible swap participant: Provided, however, that if such broker-dealer is a natural person or proprietorship, the broker-dealer must also meet the requirements of either subsection (vi) or (xi) of this section;

(x) A futures commission merchant, floor broker, or floor trader subject to regulation under the Act or a foreign person performing a similar role or function subject as such to foreign regulation, acting on its own behalf or on behalf of another eligible swap participant: Provided, however, that if such futures commission merchant, floor broker or floor trader is a natural person or proprietorship, the futures commission merchant, floor broker or floor trader must also meet the requirements of subsection (vi) or (xi) of this section; or

(xi) Any natural person with total assets exceeding at least $10,000,000.

The definition of ''eligible swap participant'' in Regulation 35.1(b)(2) is based on the list of appropriate persons set forth in Section 4(c)(3)(A)–(J) of the CEA. However, the Commission, relying on authority provided in Section 4(c)(3)(K) of the CEA, adjusted those definitions when it adopted Part 35. These adjustments reflected the international character of the swaps market by assuring that both foreign and United States entities could quality for treatment as eligible swap participants. In addition, the Commission raised the threshold for the net worth or total asset test that must be met by certain eligible swap participants. It applied this test as an indication of a swap participant's financial sophistication and background.[28] The Commission indicated its belief that the definition of ''eligible swap participant,'' as adopted, would not adversely affect the swap market as it then existed.[29]

The remaining conditions that must be satisfied by swap agreements in order

[20] 7 U.S.C. 2a. Section 2(a)(1)(B) of the Act establishes the respective jurisdiction of the CFTC and of the SEC over different instruments and restricts or prohibits certain types of securities futures.

[21] 7 U.S.C. 6b and 6o.

[22] Regulation 32.9, 17 CFR 32.9, prohibits fraud in connection with commodity options transactions.

[23] 7 U.S.C. 9 and 13(a)(2).

[24] Pub. L. No. 93–463 (1974), 88 Stat. 1389. See Commission Regulation 35.1(a) and Exemption for Certain Swap Agreements, 58 FR 5587 at 5588 (January 22, 1993) (adopting Part 35 Rules).

[25] In issuing the swap exemption, the Commission also acted pursuant to its authority to regulate options under Section 4c(b) of the CEA, 7 U.S.C. 6c(b). See Exemption for Certain Swap Agreements, 58 FR 5587 at 5589 (Jan. 22, 1993).

[26] Id. at 5588.

[27] See id. at 5589.

[28] See id. at 5589–90.

[29] See id. at 5590.

to qualify for the Part 35 exemption are meant, among other goals, to assure that the exemption does not permit the establishment of an unregulated exchange-like market in swaps.[30] These conditions require that the creditworthiness of any party having an obligation under the swap agreement must be a material consideration in entering into the agreement and prohibit a swap that is part of a fungible class of agreements, standardized as to their material economic terms, or that is entered into and traded on or through a multilateral transaction execution facility from qualifying for the Part 35 exemption. The Commission has made clear that the Part 35 exemption does not extend to transactions that are subject to a clearing system where the credit risk of individual counterparties to each other is effectively eliminated.[31]

These conditions do not prevent parties who wish to rely on the Part 35 exemption from undertaking bilateral collateral or margining arrangements nor from applying bilateral or multiparty netting arrangements to their transactions, provided however that, in the case of multilateral netting arrangements, the underlying gross obligations among the parties are not extinguished until all netted obligations are fully performed.[32] Nor is the Part 35 restriction on multilateral transaction execution facilities meant to preclude parties who engage in negotiated, bilateral transactions from using computer or other electronic facilities to communicate simultaneously with other participants, so long as they do not use such facilities to enter orders or execute transactions.[33]

Similarly, standardization of terms that are not material economic terms does not necessarily prevent an agreement from qualifying for an exemption under Part 35, provided that the material economic terms of the swap agreement remain subject to individual negotiation by the parties.[34] In this respect, the Commission has explained that:

[T]he phrase ''material economic terms'' is intended to encompass terms that define the rights and obligations of the parties under the swap agreement, and that as a result, may affect the value of the swap at origination or thereafter. Examples of such terms may include notional amount, amortization, maturity, payment dates, fixed and floating rates or prices (including method by which such rates or prices may be determined), payment computation methodologies, and any rights to adjust any of the foregoing.[35]

B. Hybrid Instruments

1. Background

In 1989, the Commission recognized that certain instruments combined characteristics of securities or bank deposits with characteristics of futures or options and wished to exclude from CEA regulation those hybrid instruments whose commodity-dependent value was less than their commodity-independent value. The Commission issued a Statutory Interpretation Concerning Certain Hybrid Instruments (''Interpretation'')[36] which excluded from regulation under the CEA and CFTC regulations debt securities within the meaning of Section 2(1) of the Securities Act of 1933 and time deposits within the meaning of 12 CFR Section 204.2(c)(1) that had the following characteristics: (1) indexation to a commodity on no more than a one-to-one basis; (2) a limited maximum loss; (3) inclusion of a significant commodity component; (4) lack of a severable commodity component; (5) no required delivery of a commodity by means of an instrument specified in the rules of a designated contract market; and (6) no marketing of the instruments as futures contracts or commodity options.[37]

Later in 1989, the Commission adopted Part 34, which exempted certain hybrid instruments with commodity option components from the CEA and from the Commission's regulations.[38] While Part 34 expanded the category of hybrid instruments that were considered to be outside of the CEA and the Commission's regulations, the Commission explicitly stated that it intended not ''to address the entire universe of hybrid instruments in the proposed rules, but rather to establish an exemptive framework'' that would apply to certain instruments in which issuers had expressed an interest to that point.[39] In 1990, the Commission issued a revised Interpretation designed to conform the Interpretation's treatment of hybrids with the treatment of hybrids in Part 34.[40] The revised Interpretation expanded the class of securities and depository accounts eligible as hybrid instruments and expanded the class of institutions eligible to transact in hybrids.

Congress included a provision in the 1992 Act permitting the Commission to exempt any transaction from all provisions of the CEA except Section 2(a)(1)(B). Using this new authority contained in Section 4(c) of the CEA, the CFTC substantially modified the Part 34 regulations to exempt certain hybrids (including, for the first time, hybrid instruments with futures-like components) from most provisions of the CEA and from the Commission's regulations.

2. Part 34

A hybrid instrument is defined in Part 34 of the Commission's regulations as an equity security, a debt security, or a depository instrument with at least one commodity-dependent component that has a payment feature similar to that of a commodity futures contract, a commodity option contract or a combination thereof.[41] Part 34 exempts such hybrids, and those transacting in and/or providing advice or other services with respect to such hybrids, from all provisions of the CEA except Section 2(a)(1)(B) of the CEA, provided that a number of conditions are met.[42] The conditions include: (1) a requirement that the issuer must receive full payment of the hybrid's purchase price;[43] (2) a prohibition on requiring additional out-of-pocket payments to the issuer during the hybrid's life or at its maturity;[44] (3) a prohibition on marketing the instrument as a futures contract or commodity option;[45] (4) a prohibition on settlement by delivery of an instrument specified as a delivery instrument in the rules of a designated contract market;[46] (5) a requirement that the hybrid be initially sold or issued subject to federal or state securities or banking laws to persons permitted thereunder to purchase the instrument;[47] and (6) a requirement that the sum of the values of the commodity-dependent components of a hybrid instrument be less than the value of the commodity-independent components.[48]

In imposing the first two conditions of Part 34's exemptions—the requirement that the issuer of a hybrid instrument receive full payment of the hybrid's purchase price and the ban on out-of-pocket payments from a hybrid purchaser or holder to the instrument's issuer—the Commission sought to limit the possible losses due to the

[30] See id. at 5590–91.
[31] See id. at 5591.
[32] See id.
[33] See id.
[34] See id. at 5590.
[35] Id. at 5590 n. 24.
[36] 54 FR 1139 (January 11, 1989).
[37] Id.
[38] 54 FR 30684 (July 21, 1989).
[39] Id.
[40] 55 FR 13582 (April 11, 1990).
[41] 17 CFR 34.2(a) (1997).
[42] 17 CFR 34.3(a) (1997).
[43] 17 CFR 34.3(a)(3)(i) (1997).
[44] Id.
[45] 17 CFR 34.3(a)(3)(ii) (1997).
[46] 17 CFR 34.3(a)(3)(iii) (1997).
[47] 17 CFR 34.3(a)(4) (1997).
[48] 17 CFR 34.3(a)(2) (1997).

commodity-dependent components of a hybrid instrument, reasoning that an instrument permitting the accrual of losses in excess of the face value of such instrument is more akin to a position in a commodity derivative than to a debt, equity, or depository instrument.[49] The third condition outlined above, a limitation on marketing the instrument as a futures contract or a commodity option, was intended to prevent purveyors of hybrid instruments from misleading investors as to the nature, legal status and form of regulatory supervision to which such instruments are subject.[50] The Commission did not want potential buyers to believe that hybrids were subject to the full protections of the CEA.

The fourth condition noted above, a prohibition on settlement by a contract market delivery instrument, was designed to guard against interference with deliverable supplies for settlement of exchange-traded futures or options contracts.[51] In adopting the fifth condition, a limitation on persons permitted to purchase an instrument, the Commission was seeking both to address customer protection concerns and Congress's concern, as embodied in Section 4(c)(2)(B)(i) of the CEA,[52] that only transactions entered into between appropriate persons may be exempted from the CEA.[53]

This sixth requirement is referred to as the ''predominance test.'' [54] It was designed in response to authorization granted by Congress in Section 4(c)(5)(A) of the CEA for the Commission to exempt hybrids, which were predominantly securities or depository instruments. The predominance test starts from the premise that hybrid instruments can be viewed as a combination of simpler instruments, the payments on which can be viewed as either commodity-independent or commodity-dependent. The payments on a hybrid's commodity-independent component are not indexed or calculated by reference to the price of an underlying commodity, including any index, spread or basket of commodities; the payments on a hybrid's commodity-dependent component are so indexed or referenced.

For a hybrid instrument to be exempted by Part 34, the present value of the returns associated with the commodity-independent component of an instrument (including any return of principal) must be greater than the ''commodity-dependent value'' of the instrument. In order to calculate the commodity-dependent value of a hybrid, Part 34 conceptually decomposes a hybrid's commodity-dependent portion into options. The absolute values of the premiums of all implicit options that are at- or out-of-the-money are summed to arrive at the commodity-dependent value of the hybrid instrument.[55] These values are calculated as of the time of issuance of the hybrid instrument.[56]

III. Issues for Comment

A. Background

As the foregoing discussion indicates, the Commission has recognized that differences between exchange-traded markets and the OTC derivatives market warrant differences in regulatory treatment. Pursuant to the exemptions, activity in the OTC derivatives market has generally been limited to decentralized, principal-to-principal transactions between large traders. This has significant regulatory implications.

The OTC derivatives market does not appear to perform the same price discovery function as centralized exchange markets. Accordingly, certain regulatory requirements related to price discovery have not been applied to the OTC derivatives market. Thus, for example, the Commission has not suggested that it should preapprove contract design in the OTC derivatives market as it does for exchanges.

Similarly, the decentralization of trading in the OTC market and the relative sophistication of the participants have meant that issues of financial integrity and customer protection differ from exchange markets. Thus for example, while the Commission has retained its fraud authority for the swap market, it has not required segregation of customer funds.

Developments in the market in the last five years, however, indicate the need to review the current exemptions. As mentioned above, new end-users have entered the market, new products have been developed, some products have become more standardized, and systems for centralized execution and clearing have been proposed. The terms and conditions of the exemptions may need adjustment to reflect changes in the marketplace and to facilitate continued growth and innovation.

In addition, the explosive growth in the OTC market in recent years has been accompanied by an increase in the number and size of losses even among large and sophisticated users which purport to be trying to hedge price risk in the underlying cash markets. Market losses by end-users may lead to allegations of fraud or misrepresentation after they enter transactions they do not fully understand. Moreover, as the use of the market has increased, entities such as pension funds and school districts have been affected by derivatives losses in addition to corporate shareholders.[57]

Accordingly, the Commission believes it is appropriate at this time to consider whether any modifications to the scope or the terms and conditions of the swap and hybrid instrument exemptions are needed to enhance the fairness, financial integrity, and efficiency of this market. The Commission reiterates that the items listed below are intended solely to encourage useful public comment.

The Commission urges commenters to analyze the benefits and burdens of any potential modifications in light of current market realities. In some areas, regulatory relief or expanded access to the market may be warranted while in others additional safeguards may be appropriate. The Commission is especially interested in whether modifications can be designed to stimulate growth. This might be accomplished, for example, by increasing legal certainty and investor confidence, thereby attracting new market participants, or by facilitating netting and other transactional efficiencies, thereby reducing costs. As discussed below, the Commission also welcomes comment on the extent to which certain matters can be adequately addressed through self-regulation. Finally, the Commission invites other regulators to express their views on the issues raised in this release and, in particular, how best to achieve effective coordination among regulators. The Commission anticipates that, where other regulators have adequate programs or standards in place to address

[49] Regulation of Hybrid Instruments, 58 FR 5580 at 5585 (January 22, 1993) (promulgating current Part 34 Rules).

[50] Regulation of Hybrid Instruments, 54 FR 1128 at 1135 (January 11, 1989) (proposing original Part 34 Rules).

[51] 58 FR 5580 at 5582.

[52] 7 U.S.C. 6(c)(2)(B)(i).

[53] 58 FR 5580 at 5585.

[54] 17 CFR 34.3(a)(2) (1997).

[55] More specifically, the absolute net value of all put option premiums with strike prices less than or equal to the reference price would be added to the absolute net value of all call option premiums with strike prices greater than or equal to the reference price. 58 FR 5580 at 5584. ''Reference price'' is defined in Regulation 34.2(g), 17 CFR 34.2(g), ''as the nearest current spot or forward price at which a commodity-dependent payment becomes non-zero, or in the case where two potential reference prices exist, the price that results in the greatest commodity-dependent value.''

[56] 58 FR 5580 at 5584–85.

[57] See 1997 GAO Report at 71.

particular areas, the Commission would defer to those regulators in those areas.

B. Potential Changes to Current Exemptions

The exemptions provided by Part 34 and Part 35 reflect circumstances in the relevant market at the time of their adoption. As noted, the Commission believes that it should review these exemptions in light of current market conditions. At the most general level, three issues are presented with respect to these exemptions: first, what criteria should be applied in determining whether a transaction or instrument is eligible for exemption from the CEA; second, what should be the scope of that exemption; and third, what conditions should be imposed, if any, to ensure that the public interest and the policies of the CEA are served.

1. Eligible Transactions

(a) Swaps. Part 35 sets forth certain criteria that an instrument must meet in order to qualify for the swap exemption. These criteria impose restrictions upon the design and execution of transactions that distinguish the exempted swap transactions from exchange-traded products.[58] Given the changes in the swap market since Part 35 was adopted, the Commission seeks comments as to whether the criteria set forth in Part 35 continue to provide a meaningful, objective basis for exempting transactions from provisions of the CEA and CFTC regulations.

In particular, some swap agreements have become highly standardized. The Part 35 exemption does not extend to ''fungible agreements, standardized as to their material economic terms.'' The Commission seeks comment on whether this part of the Part 35 criteria provides sufficient guidance for parties involved in swaps. Parties may have difficulty in readily assessing whether a particular transaction qualifies for treatment under the Part 35 exemption.

In order to provide greater clarity, the Commission could adopt additional or alternative requirements governing exempted swap agreements. For example, the Commission could provide additional detail concerning the concept of fungibility in this context. The Commission could also clearly specify which terms of an agreement would be considered to be material economic terms under Part 35.

Moreover, subject to consideration of the requirements set forth in Sections 4(c)(1) and (c)(2) of the CEA, the Commission could consider expanding the scope of the swap exemption so that it more clearly applies to certain classes of transactions that exhibit some degree of standardization. In this regard, while Section 4(c)(5)(B) authorizes the Commission to exempt non-fungible swaps, the lack of fungibility is not a necessary criterion under Sections 4(c)(1) or (c)(2) for exercising exemptive authority.

Request for comment. The Commission requests comment on whether the swaps exemption should be extended to fungible instruments and, if so, under what circumstances. The Commission is also seeking more general comment as to whether the swaps exemption continues to fulfill its stated goals. In this regard, the Commission is interested in commenters' views on what changes in the current rules may be needed to assure that Part 35 provides legal certainty to the current market and fulfills the statutory goals set forth in Section 4(c) of the CEA.

In particular, the Commission requests comment on the following questions.

1. In what ways has the swap market changed since the Commission adopted Part 35. Please address:

(a) the nature of the products;

(b) the nature of the participants, both dealers and end-users;

(c) the location of transactions;

(d) the business structure of participants (e.g., the use of affiliates for transacting OTC derivatives);

(e) the nature of counterparty relationships;

(f) the mechanics of execution;

(g) the methods for securing obligations; and

(h) the impact of the current regulatory structure on any of the foregoing.

2. What are the mechanisms for disseminating the prices for swap transactions?

3. Does the swap market serve as a vehicle for price discovery in underlying cash markets? If so, how? Please describe.

4. To what extent is the swap market used for hedging? To what extent is it used for speculation? Please provide details.

5. Is there a potential for transactions in the swap market to be used to manipulate commodity prices? Please explain.

6. To what degree is the swap market intermediated, i.e., to what extent do entities

(a) act as brokers bringing end-users together?

(b) act as dealers making markets in products?

Please describe the intermediaries in the market and the extent and nature of their activities.

7. To what extent do swap market participants act in more than one capacity (e.g., as principal in some transactions and broker in others)?

8. In light of current market conditions, do the existing Part 35 requirements provide reasonable, objective criteria for determining whether particular swaps transactions are exempted under the CEA? Should the meaning of terms such as ''fungible,'' ''material economic terms,'' or ''material consideration'' be clarified or modified in any way? If so, how?

9. What steps can the Commission take to promote greater legal certainty in the swap market?

10. What types of documentation are relevant in determining whether a particular transactions falls within the swaps exemption and/or the Policy Statement? Should the Commission set standards in this regard?

11. If the current restrictions set forth in the Part 35 requirements negatively affect or potentially limit the OTC market or its development in the United States, what changes would alleviate the negative effects? Should the exemption in Part 35 be broadened in any manner?

12. What steps, if any, can the Commission take to promote greater efficiency in the swap market, such as for example, by facilitating netting?

13. Are any changes in regulation relating to the design or execution of exempted swap transactions needed to protect the interests of end-users in the swap market? Are there changes in regulation that would attract new end-users to the market or lead existing end-users to increase their participation?

14. Should distinctions be made between swaps that are cash-settled and swaps that provide for physical delivery? Please explain.

15. Should transactions in fungible instruments be permitted under the swaps exemption?

16. To what extent should the creditworthiness of a counterparty continue to be required to be a material consideration under the swaps exemption? Please explain.

(b) Hybrid instruments. Part 34 was designed to exempt from Commission regulation instruments in which the commodity futures or option characteristics were subordinate to their characteristics as securities and deposits. Some experienced practitioners have stated that the definition of a hybrid instrument under Part 34 is extremely complex and difficult to understand and to apply. Moreover, the Commission staff has

[58] CFTC, OTC Derivatives Markets and Their Regulation 78–79 (1993) (''CFTC OTC Derivatives Report'') (discussing swaps exemption).

recently reviewed several hybrid instruments that had very significant commodity components yet were apparently eligible for exemption under Part 34's technical definition.

For example, the Commission staff recently reviewed an instrument structured as a medium-term debt instrument paying a small quarterly coupon rate. At maturity, after subtracting out a ''factor'' reflecting certain costs borne by the issuer, the purchaser would receive a payment that was based on the performance of an index of futures contract prices with no upward limit on the commodity-based return. Moreover, the holder could lose its entire investment based on a downward movement in the commodity index. Commission staff believed that, under Part 34 as currently written, the instrument apparently would be exempt from regulation under the CEA. A regulatory definition that treats the entire principal as ''commodity independent'' despite the fact that all of the principal on this instrument could be lost as a direct result of movement in the commodity index warrants additional analysis.

Another conceptual concern with the current definition is the manner in which it assigns value to the ''commodity dependent'' component. Futures-like elements are analyzed as a combination of offsetting at-the-money puts and calls. The sum of the absolute values of these option premiums is the assigned value of the futures-like component. Some observers have suggested that this test is not an appropriate measure of the commodity dependent value. As Part 34 is currently structured, whether or not an instrument qualifies for an exemption depends critically on the total volatility of the commodity-dependent portion. This creates three potential problems. First, the technical knowledge needed to identify the commodity-dependent volatility may be a challenge for some market participants. Second, for two instruments that are identical except for their commodity-dependent volatility, one might be classified as exempt while the other might not. Indeed, if the volatility of the underlying commodity changes through time, the classification of identical hybrid instruments issued on different dates might be different. Thus, Part 34 may create some undesirable ambiguity regarding which instruments qualify for an exemption. Third, it appears to be paradoxical that short-term instruments are more likely to be classified as exempt than long-term instruments even though short-term instruments generally are more akin to exchange-traded futures in many respects.

If the Commission were to modify or to clarify the predominance test in a way that resulted in more instruments being found to have a predominant commodity-dependent component, the Commission could exercise its authority under Section 4(c) to exempt some or all of such instruments subject to specified terms and conditions. As is the case today, instruments in which the commodity-independent component was predominant would not be subject to any such terms and conditions.

Request for comment. The Commission requests comment on the foregoing analysis. It welcomes alternative suggestions for analyzing hybrid instruments and for simplifying the definition of exempt hybrid instruments.

17. In what ways has the hybrid instrument market changed since the Commission adopted Part 34? Please address:

(a) the nature of the products;

(b) the nature of the participants, both dealers and end-users;

(c) the location of transactions;

(d) the nature of the counterparty relationships;

(e) the mechanics of execution;

(f) the methods for securing obligations; and

(g) the impact of the current regulatory structure on any of the foregoing.

18. What are the mechanisms for disseminating prices for hybrid instrument transactions?

19. Does the hybrid instrument market serve as a vehicle for price discovery in underlying commodities? If so, how? Please describe.

20. To what extent is the hybrid instrument market used for hedging? To what extent is it used for speculation? Please provide details.

21. Is there a potential for transactions in the hybrid instrument market to be used to manipulate commodity prices? Please explain.

22. To what degree is the hybrid instrument market intermediated, i.e., to what extent do entities

(a) act as brokers bringing end-users together?

(b) act as dealers making markets in products?

Please describe the intermediaries in the market and the extent and nature of their activities and the extent to which transactions in these instruments are subject to other regulatory regimes.

23. To what extent do hybrid instrument market participants act in more than one capacity (e.g., as a principal in some transactions and broker in others)?

24. In light of current market conditions, do the existing Part 34 requirements provide reasonable, objective criteria for determining whether a particular hybrid instrument performs the functions of a futures or option or those of a security or depository instrument? Are the criteria easily understood and applied by participants in the market? Do they properly distinguish types of instruments? If not, should they be changed? How?

25. What steps, if any, can the Commission take to promote greater legal certainty in the hybrid instrument market? Please explain.

26. Should Part 34 be amended to reflect more accurately or more simply whether commodity-dependent components predominate over commodity-independent components?

27. Are changes in regulation relating to the design or execution of transactions in exempted hybrid instruments needed to protect the interests of end-users in the hybrid instrument market? Are there changes in regulation that would attract new end-users to the market or lead existing end-users to increase their participation?

28. Should the Commission exercise its authority to exempt any hybrid instruments with a predominant commodity component subject to specified terms and conditions? Please explain.

2. Eligible Participants

Section 4(c)(2) states that ''the Commission shall not grant any exemption under'' authority granted therein ''unless the Commission determines that . . . the agreement, contract or transaction will be entered into solely between appropriate persons.'' Section 4(c)(3) further states that ''the term 'appropriate person' shall be limited'' to the classes of persons specifically listed therein including ''[s]uch other persons that the Commission determines to be appropriate in light of their financial or other qualifications or the applicability of appropriate regulatory protections.''

(a) Swaps. Part 35 currently contains a requirement that an exempt swap agreement be between eligible swap participants, as defined in Regulation 35.1(b)(2). The list of eligible swap participants in Part 35 is based substantially on the list of ''appropriate person'' defined in the CEA. The Commission seeks comments as to whether the current list of eligible swap participants should be modified in any way. The Commission requests comment regarding whether the definition is adversely affecting the

swaps market by excluding persons who should be included or, alternatively, by including persons who are not, or should not be, active in the current market. The Commission also seeks comment on whether additional persons should be added and, if so, whether additional protections would be appropriate. In either case, commenters are asked to describe such persons and the protections they need, if any.

Any potential change must be analyzed in light of the stated Congressional intent that any exempted transaction must be entered into solely by appropriate persons as defined in Section 4(c)(3)(A)–(K) of the Act. In addition, any changes to the definition of eligible swap participant would be considered in light of any other relevant changes that may result from Commission follow-up to this concept release.

(b) Hybrid instruments. As discussed above, if the Commission were to modify the predominance test under Part 34, it might also decide to exempt certain commodity-like hybrid instruments subject to specified terms and conditions. The Commission invites analysis on the potential applicability of an appropriate person standard in that context.

Request for comment. 29. Should the current list of eligible swap participants be expanded in any way? Should it be contracted in any way? If so, how and why?

30. Are there currently eligible swap participants who would benefit from additional protections? Are there potential swap participants who are not currently eligible but would be appropriate subject to additional protections? In either case, please describe the types of persons and the types of protections.

31. Should the Commission establish a class of eligible participants for the trading of hybrid instruments with a predominant commodity-dependent component? If so, please describe.

32. Is it advisable to use a single definition of sophisticated investor whenever that concept arises under the Commission's regulations? If so, what definition should apply?

3. Clearing

Clearing of swaps is not permitted under Part 35. The Commission expressly stated that:

> The exemption does not extend to transactions that are subject to a clearing system where the credit risk of individual members of the system to each other in a transaction to which each is a counterparty is effectively eliminated and replaced by a system of mutualized risk of loss that binds members generally whether or not they are counterparties to the original transaction.[59]

Regulation 35.2 provides, however, that ''any person may apply to the Commission for exemption from any of the provisions of the Act (except 2(a)(1)(B)) for other arrangements or facilities, on such terms and conditions as the Commission deems appropriate. * * *'' The Commission included this proviso in order to hold open the possibility that swap agreements cleared through an organized clearing facility could be exempted from requirements of the Act under appropriate terms and conditions. The Commission affirmatively stated that the proviso ''reflects the Commission's determination to encourage innovation in developing the most efficient and effective types of systemic risk reduction'' and that ''a clearing house system for swap agreements could be beneficial to participants and the public generally.'' [60]

In the years since Part 35 was issued, interest in developing clearing mechanisms for swaps and other OTC derivatives has increased. The Commission has had extensive discussions with several organizations engaged in designing clearing facilities.[61] The Commission believes that these efforts have reached a stage where it is necessary to consider and to formulate a program for appropriate oversight and exemption of swaps clearing.

Clearing organizations can provide many benefits to participants, such as the reduction of counterparty credit risk, the reduction of transaction and administrative costs, and an increase in liquidity. They also can provide benefits to the public at large by increasing transparency. These benefits are obtained at the cost of concentrating risk in the clearing organization. Accordingly, a greater need may exist for oversight of the operations of a clearing organization than for any single participant in an uncleared market.

In the 1993 CFTC OTC Derivatives Report, the Commission stated that the regulatory issues presented by a facility for clearing swaps ''would depend materially upon the facility's design, such as, for example, the extent to which the construction of such a facility is consistent with the minimum standards for netting systems recommended by the Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries (Lamfalussy Report).'' [62] Comment is requested concerning the usefulness of the Lamfalussy standards in this context.

The Commission has identified the following core elements that should be addressed: the functions that an OTC derivatives clearing facility would perform; the products it would clear; the standards it would impose on participants; and the risk management tools it would employ. As discussed below, the Commission invites comments on each of these topics.

(a) Functions. An OTC derivatives clearing facility could perform a variety of functions ranging from simple trade comparison and recordation to netting of obligations to the guarantee of performance. For example, the Commission notes that, in jurisdictions other than the U.S., there may not be a clearing guarantee, or the guarantee may attach at a time other than the initiation of the trade. The Commission requests comment on which of these functions, if any, should be permitted and under what circumstances.

(b) Products cleared. The definition of the term ''swap agreement'' in Regulation 35.1(b)(1) is very broad. Financial engineers are continually designing new products that fall within that definition but have novel characteristics. As a practical matter, the Commission believes that any OTC derivatives clearing facility would be most likely in the context of ''plain vanilla'' products for which prices can be readily established and for which there is some standardization as to

[59] 54 FR 5587 at 5591.

[60] Id. at 5591 n.30.

[61] Not all the proposed arrangements have included the mutualization of risks among members of a clearing organization. In some cases, a single entity proposed to support the clearing arrangements using its own assets.

[62] CFTC OTC Derivatives Report at 136–37. The Lamfalussy standards are the following:

1. Netting schemes should have a well-founded legal basis under all relevant jurisdictions;

2. Netting scheme participants should have a clear understanding of the impact of the particular scheme on each of the financial risks affected by the netting process;

3. Multilateral netting systems should have clearly-defined procedures for the management of credit risks and liquidity risks which specify the respective responsibilities of the netting provider and the participants. These procedures should also ensure that all parties have both the incentives and the capabilities to manage and contain each of the risks they bear and that limits are placed on the maximum level of credit exposure that can be produced by each participant.

4. Multilateral netting systems should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single net-debit position;

5. Multilateral netting systems should have objective and publicly-disclosed criteria for admission which permit fair and open access; and

6. All netting schemes should ensure the operational reliability of technical systems and the availability of back-up facilities capable of completing daily processing requirements.

terms. The Commission requests comment on whether the range of products that may be cleared through an OTC derivative clearing facility, or their terms of settlement, should be limited in any way.

(c) Admission standards. The class of eligible swap participants ias defined in Regulation 35.1(b)(2). There is an inherent tension between the desire to promote open and competitive markets by allowing access.[63] and the desire to maintain financial integrity by imposing admission standards. The Commission requests comment on what standards, if any, it should establish, or permit an OTC derivatives clearing facility to establish, for admission as a clearing participant. Comment is also requested on whether clearing should be limited to transactions undertaken on a principal-to-principal basis or whether agency transactions should be included.[64]

(d) Risk management tools. An OTC derivatives clearing facility could choose from among many potential risk management tools. These include capital requirements for participants, reporting requirements, position or exposure limits, collateral requirements, segregation requirements, mark-to-market or other valuation procedures, risk modeling programs, auditing procedures, and information-sharing arrangements. The clearing facility could also draw upon its own capital, its lines of credit, any guarantee funds financed by clearing members, or other arrangements for sharing losses among participants. The relevance of these various items would depend, of course, on the functions the clearing facility performed and the products its cleared. The Commission requests comment on how best to assure that a clearing facility uses appropriate risk management tools without preventing flexibility in the design of such tools or inhibiting the evolution of new risk management technology.

(e) Other considerations. Permitting OTC products to be cleared may make them more like exchange-traded products. The Commission welcomes comment on how best to promote fair competition and even-handed regulation in the context of the clearance of OTC derivative products.

In approving Part 35, the Commission noted that it was ''mindful of the costs of duplicative regulation [65] and added the proviso to Regulation 35.2 that the Commission would consider ''the applicability of other regulatory regimes'' in addressing petitions for further exemptive relief relating to swaps facilities. The Commission recognizes that existing clearing facilities that are regulated by another federal regulatory authority because the clear products subject to that regulator's jurisdiction may wish to develop swap clearing facilities. The Commission requests comment on how to address this situation.

Request for comment. 33. Are any swaps currently subject to any type of clearing function, either in the U.S. or abroad? If so, please provide details.

34. Would permitting swap clearing facilities promote market growth and assist U.S. participants in remaining competitive? If so, please describe the appropriate elements of a program for the oversight of swap clearing organizations.

35. Should there be a limit on the clearing functions permitted for swaps?

36. Should there be a limit on the range of products that may be cleared through a swap clearing facility?

37. Should there be standards for admission as a clearing participant?

38. What types of risk management tools should a clearing facility employ?

39. To what degree would cleared swaps be similar to exchange traded products? How best can the Commisison promote fair competition and even-handed regulation in this context?

40. How should the Commission address OTC derivative clearing facilities that are subject to another regulatory authority by virtue of conducting activities subject to that regulator's jurisdiction?

4. Transaction Execution Facilities

Regulation 35.2(d) provides that a swap agreement may not be entered into or traded on or through a multilateral transaction execution facility (''MTEF'').[66] In the release issuing Part 35, the Commission described an MTEF as:

> [A] physical or electronic facility in which all market makers and other participants that are members simultaneously have the ability to execute transactions and bind both parties by accepting offers which are made by one member and open to all members of the facility.[67]

The Commission specified that the MTEF limitation did not:

> [P]reclude participants from engaging in privately negotiated bilateral transactions, even where these participants use computer or other electronic facilities, such as ''broker screens,'' to communicate simultaneously with other participants so long as they do not use such systems to enter orders to execute transactions.[68]

The Commission noted that there were no swap MTEFs in existence at that time.[69] Consistent with the proviso in Regulation 35.2, the Commission invited application for appropriate exemptive relief for such facilities as they were developed.[70]

The Commission is requesting comment on whether the regulatory approach to execution facilities should be modified in any way. Specifically, the Commission invites comment on whether the description of MTEFs set forth above is sufficiently clear, whether it accurately delineates the relevant features, and how the Commission should address other types of entities that facilitate execution, such as market makers or bulletin board services. The Commission recognized when it promulgated Part 35 that MTEFs ''could provide important benefits in terms of increased liquidity and price transparency.'' [71] The Commission seeks comment on whether it should permit swaps to be traded through an MTEF or other similar facilities and, if so, what terms and conditions should be applied. It also seeks comment on the degree to which such trading would be similar to exchange trading and the degree to which similar safeguards are needed. As in the case of clearing facilities, the Commission is mindful of the need to promote fair competition between and even-handed regulation of exchanges and the swap market.

Part 36 of the Commission's regulations [72] was designed to allow reduced regulation for exchange trading limited to sophisticated traders. It was intended to ''permit * * * exchange-traded products greater flexibility in competing with foreign exchange-traded products and with both foreign and domestic over-the-counter transactions while maintaining basic customer protection, financial integrity and other protections associated with trading in an exchange environment.'' [73] No contract market has applied for exemption under Part 36. An analysis of the perceived strengths and weaknesses of Part 36 may be a useful starting point in determining an appropriate regulatory regime for execution facilities. Accordingly, the Commission requests comment on whether elements

[63] See Section 15 of the Act, 7 U.S.C. 19.

[64] Current Part 35 allows only certain eligible swap participants to act on the behalf of another eligible swap participant. See 17 CFR 35.1(b)(2) (1997).

[65] 58 FR 5587 at 5591 n.30.

[66] 17 CFR 35.2(d) (1997).

[67] 58 FR 5587 at 5591.

[68] Id.

[69] Id.

[70] Id.

[71] Id.

[72] 17 CFR 36.1–36.9 (1997).

[73] Section 4(c) Contract Market Transactions, 60 FR 51323 (Oct. 2, 1995).

of Part 36 should be applicable to execution facilities. Proposals for modification of Part 36 are welcome.

Request for comment. 41. Should the definition of MTEF be changed in any way to provide more clarity?

42. Are MTEFs or other types of execution facilities currently being used for swap trading, either in the U.S. or abroad? If so, please provide details.

43. What terms and conditions, if any, should be applied to execution facilities? Please address potential competitive effects on current exchange trading and the degree to which similar requirements should be made applicable. Please also address the strengths and weaknesses of current Part 36 for this purpose.

5. Registration

Registration has been called ''the kingpin in [the CEA's] statutory machinery, giving the Commission the information about participants in commodity trading which it so vitally requires to carry out its other statutory functions of monitoring and enforcing the Act.[74] Registration identifies participants in the markets and allows for a ''screening'' process by requiring applicants to meet fitness standards. Registration may also facilitate enforcement of fraud prohibitions. In addition, the requirement to register may trigger other standards and obligations for registrants under the CEA and Commission rules.[75] Part 34 and Part 35 of the Commission's regulations currently exempt parties from the registration requirements of the Act with respect to qualifying transactions.

The Commission seeks comment on whether registration requirements for dealers or intermediaries would be useful or necessary for the Commission in its oversight of the OTC derivatives market. Registration would identify key players in the OTC derivatives markets but would not necessarily trigger the full range of regulations applicable to registered persons involved in exchange-traded futures and options. Instead it could be related to separate and limited OTC derivatives market regulations. Alternatively, the Commission seeks comment on whether it would be appropriate to adopt a notice filing, requiring parties involved in certain activities within the OTC derivatives markets to identify themselves to the Commission.

In addressing this issue, commenters should consider, among other things, whether a distinction should be made between swaps and hybrid instruments. Comment also would be useful on whether it would be sufficient that a person is registered or regulated by another federal agency so that the Commission should waive any registration requirements for such persons with respect to OTC derivatives transactions.

Differences between the OTC derivative market and exchange-traded futures and option markets may affect the need for registration in the context of OTC derivatives trading. For example, since swap transactions occur among institutional participants who bilaterally negotiate an agreement, there may be reduced value added in requiring dealers or advisors to undergo fitness checks. Such institutional participants would likely have the resources to investigate the fitness of potential counterparties and advisors.

Request for comment. 44. What benefits might arise from requiring registration of dealers, intermediaries, advisors, or others involved in OTC derivative transactions? Should any requirement be in the form of a notice filing or full registration?

45. What criteria should be used in determining the types of transactions and the types of market participants subject to registration requirements?

46. Should regulation by other federal agencies be a factor in permitting an exemption from registration or notice filing?

47. What role should membership in a designated self-regulatory organization play?

6. Capital

Capital requirements have long been considered important for assuring a firm's ability to perform its obligations to its customers and to its counterparties and for controlling systemic risk. The Commission currently imposes no capital requirements on participants in the OTC derivatives markets. Given the sophistication of the participants, the generally principal-to-principal nature of their relationships with one another, the fact that OTC derivatives dealers typically do not hold customer's funds in an agency relationship (in contrast to futures commission merchants or broker-dealers), and the applicability of other regulatory capital standards to many market participants, capital requirements may be unnecessary.

The Commission seeks to explore whether regulatory capital might serve a useful function in the context of the OTC derivatives markets. For example, regulatory capital might provide an OTC derivatives dealer's counterparties with independent assurance of the creditworthiness of the dealer or might prevent the dealer from assuming excessive leverage. Capital requirements might also serve the function of providing early warning of financial difficulties.

Request for comment. 48. Are any capital requirements for OTC derivatives dealers needed? Why? What benefits would they provide to the market? What burdens would they impose?

49. Should any reporting or disclosure requirements be established for dealers as an alternative to capital requirements in order to permit counterparties to evaluate their creditworthiness adequately? Please explain.

50. Do ratings by nationally recognized statistical rating organizations fulfill the function of assuring end-user counterparties of the creditworthiness of OTC derivatives dealers?

7. Internal Controls

The importance of internal controls for financial services firms generally and for derivatives dealers in particular is widely recognized.[76] The Commission has long required information concerning risk management and internal control systems from FCMs, as well as prompt reporting of any material inadequacies in such systems.[77] Close attention to risk management and internal control systems may be especially important in an environment where capital standards (whether imposed by regulators or internally) are reduced and are based on the results of internal value-at-risk models and calculations rather than on more standardized ''haircuts.'' While a

[74] *Commodity Futures Trading Commission* v. *British American Commodity Options Corp.*, 560 F.2d 135 at 139–40 (2d Cir. 1977) *cert. denied*, 438 U.S. 905 (1978).

[75] *See, e.g.*, Sections 8a(2) and 8a(3) of the Act (statutory disqualification) and Regulation 1.12 (requirement that registered futures commission merchants (''FCMs'') and registered introducing brokers (''IBs''), or any person who files an application to be so registered, notify the Commission if its capital falls below minimum capital requirements); Regulation 1.15 (risk assessment reporting for registered FCMs); Regulation 1.17 (minimum capital requirements for registered FCMs and registered IBs); Regulation 4.21 (requirement that commodity pool operators (''CPOs'') who are registered or required to be registered deliver a disclosure document to clients or potential clients). Other regulations, however, may be applicable to parties whether or not they are registered or required to be registered. *See, e.g.*, Part 189 (large trader reporting requirements).

[76] See, e.g., DPG Framework at 13–22; IOSCO, The Implications for Securities Regulators of the Increased use of Value at Risk Models by Securities Firms, Section 2 (Jul. 1995); Basle Committee on Banking Supervision, Framework for the Evaluation of Internal Control Systems at 1 (Jan. 1998); Group of Thirty, Derivatives: Practices and Principles at 2 (1993).

[77] See, e.g., Regulations 1.14(a)(1)(ii); 1.15(a)(1)(ii); 1.16(e)(2).

complete discussion of internal control programs is beyond the scope of this release, the following elements of such a program are generally considered particularly important: effective models for measuring market and credit risk exposure; careful procedures for continuously validating those models, including rigorous backtesting and stress testing; netting arrangements that are enforceable in the relevant jurisdictions (and programs to review their enforceability on a regular basis); and a risk monitoring unit which reports directly to senior management, is independent of the business units being monitored, and has the necessary training and resources to accomplish its control objectives.

Request for comment. 51. Would OTC derivatives market participants benefit from internal control guidelines? If so, what market participants should be covered?

52. What provisions should be included in internal control requirements, if any?

53. How should compliance with any internal control requirements be monitored (e.g., regular audits, periodic spot checks, required reports)?

54. Who should be responsible for monitoring compliance with any internal control requirements (e.g., regulatory agencies, SROs, independent auditors)?

55. Could and should internal control standards serve as a substitute for regulatory capital requirements?

8. Sales Practices

As noted in the Introduction, a significant number of participants in the OTC derivatives markets have experienced large financial losses since the Commission's last regulatory initiatives involving OTC derivatives. The 1997 GAO Report notes that ''[s]ales practice concerns were raised in 209, or 58 percent, of [the] losses [reviewed in the Report] and were associated with an estimated $3.2 billion in losses.'' [78] Size and sophistication of a market participant may not provide meaningful protection against sales practice concerns, such as fraud.

The parties to OTC derivatives transactions are commonly referred to as end-users and dealers.[79] End-users and OTC derivatives dealers may have differing views concerning the respective responsibilities of the parties to an OTC derivatives transaction. According to a survey undertaken in conjunction with the GAO Report, ''about one-half of all end-users of plain vanilla or more complex OTC derivatives believed that a fiduciary relationship of some sort existed in some or all transactions between them and their dealer.'' [80] By contrast, ''two dealer groups issued guidance asserting that such transactions are conducted on a principal-to-principal, or an 'arm's-length,' basis unless more specific responsibilities are agreed to in writing or otherwise provided by law.'' [81] These differences in view can create problems, especially because of the extraordinary complexity of some OTC derivatives instruments and the information disparity between a derivatives dealer and many end-users. Therefore, comments concerning whether there is a need for sales practice rules applicable to OTC derivatives dealers would be useful.

In granting the Part 35 swaps exemption, the Commission retained the applicability of its basic antifraud and antimanipulation authority.[82] In addition, some OTC derivatives transactions are subject to sales practice standards administered by other financial regulatory agencies. For example, both the Office of the Comptroller of the Currency and the Federal Reserve Board have issued guidance addressing sales practice issues in the context of a bank's overall responsibilities for managing the risks of its financial activities, including OTC derivatives.[83]

The Commission seeks comments concerning potential sales practice standards for principal-to-principal transactions between dealers and end-users. The Commission would also welcome information from commenters concerning the volume of transactions, if any, in which dealers act strictly as agents, rather than principals, in facilitating transactions between two end-users and whether any specific sales practice rules should apply to such agency transactions. Likewise, the Commission would welcome comments on the volume of transactions in which dealers trade directly with other dealers for their own proprietary accounts and whether any specific sales practice rules should apply to those dealer-to-dealer transactions.

(a) Disclosure. Traditionally, the most fundamental regulatory protection in the area of sales practices has been the duty to disclose risks and other material information concerning transactions to potential customers. Disclosure concerns have often been raised with respect to OTC derivatives transactions. For example, the DPG Framework, in its section on counterparty relationships, states that dealers should consider providing new end-users with ''[g]eneric [r]isk [d]isclosure,'' which it characterizes as ''disclosure statements generally identifying the principal risks associated with OTC derivatives transactions and clarifying the nature of the relationship between the [dealer] and its counterparties.'' [84] This section of the DPG Framework goes on to provide additional details on the nature of the relationship to be clarified, stating the DPG's view that ''OTC derivatives transactions are predominantly arm's-length transactions in which each counterparty has a responsibility to review and evaluate the terms and conditions, and the potential risks and benefits, of prospective transactions * * *.'' [85] However, the DPG Framework provides no further guidance as the nature or content of the generic risk disclosure.[86] Comment is

[78] 1997 GAO Report at 71.

[79] By ''end-users'' the Commission is referring generally to participants who use derivatives to manage financial risks and opportunities that arise in the course of their businesses. Dealers are distinguished from end-users by their willingness to make two-way markets in OTC derivatives, either for end-users or for other dealers. *See* however, Derivatives Policy Group, Framework for Voluntary Oversight (Mar. 1995) (''DPG Framework'') (the Framework was developed by a group of six major investment firms). The DPG Framework refers to dealers as ''professional intermediaries'' and to end-users as ''nonprofessional counterparties.'' This difference in articulation is symptomatic of the differing views that sometimes exist among the participants in these markets concerning their respective roles.

[80] 1997 GAO Report at 5.

[81] *Id. See DPG Framework* at 9; and Federal Reserve Bank of New York, Principles and Practices for Wholesale Financial Market Transactions 1 (Aug. 17, 1995) (the Principles and Practices were developed by a group of six financial industry trade associations in coordination with the Federal Reserve Bank of New York).

[82] *See* 17 CFR 35.2 (1997).

[83] *See, e.g.,* OCC, Banking Circular 277: Risk Management of Financial Derivatives, BC–277, 1993 WL 640326 (OCC) (Oct. 23, 1993); OCC Bulletin, Questions and Answers Re: BCC 277, OCC 94–31, 1994 WL 194290 (OCC) (May 10, 1994); and Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations, [SR 93–69 (FIS)], (Dec. 20, 1993). These are not sales practice standards in the usual sense but bank risk management standards.

[84] DPG Framework at 37. The 1997 GAO Report recommends that the CFTC and SEC establish a mechanism for determining that the DPG firms are, in fact, following this and other sales practice standards in the DPG Framework.

[85] Id.

[86] The section of the DPG Framework on risk management controls lists five basic risks of OTC derivative transactions: market risk, credit risk, liquidity risk, legal risk, and operational risk. *Id.* at 14–15. in addition to these firm-specific risks, the CFTC OTC Derivatives Report lists a number of potential risks arising from OTC derivatives activities generally, including the complexity of the derivatives marketplace, the fact that dealer activity tends to be concentrated in a relatively small number of large entities, the lack of transparency,

Continued

solicited on whether risk disclosure should be required and, if so, the nature and content of such disclosure.

(b) Customer information. Comment is also solicited on whether it would be appropriate to require the dealer to obtain certain information from the end-user. Such information might include, for example:

- net worth information;
- information confirming that the end-user is within the class of eligible participants set out in Section 35.1 of the Commission's regulations;[87] or
- information demonstrating that the end-user is authorized to enter into the transaction.

(c) Other possible sales practice rules. Potential sales practice rules might also include provisions requiring dealers to supervise sales personnel and other employees responsible for handling the accounts of end-user customers. One element of such supervision might be to ensure that sales personnel are properly trained.

The Commission also wishes to consider what regime, if any, would be appropriate for overseeing the implementation and enforcement of any sales practice rules for OTC derivatives, including the costs and benefits of alternative oversight mechanisms. In that context, the Commission is seeking comments on: (1) the appropriate direct regulatory role of the CFTC with respect to potential sales practice rules; (2) the appropriate regulatory role of other financial regulatory agencies, including the applicability of any sales practice rules administered by other agencies and the degree of deference that should be accorded to such rules; and (3) the appropriate sales practice role of industry self-regulatory bodies, including the degree of CFTC oversight necessary to assure that any industry self-regulatory standards are properly implemented and enforced.

Request for comment. 56. Since Part 35 was adopted, has the swap market experienced significant problems concerning fraud or sales practice abuses? Since Part 34 was adopted, has the hybrid instrument market experienced significant problems concerning fraud or sales practice abuses? If so, please describe.

57. Is there a need for any sales practice rules in the OTC derivatives market? If so, what should the rules provide, and to whom and under what circumstances should they be applicable?

58. Is there a need for risk disclosures by OTC derivatives dealers to end-users? If so, what risks should be disclosed?

59. Should OTC derivatives dealers be required to supplement any required generic risk disclosure statement with additional firm- or transaction-specific disclosures? If so, what should such disclosures cover?

60. What kind of disclosures, if any, should dealers make to end-users clarifying the nature of the relationship between the parties? Should there be rules establishing duties of the OTC derivatives dealer to its customers, and if so, what should they require?

61. What kind of disclosures, if any, should dealers make concerning the material terms of OTC derivatives contracts, including methods for calculating price, value, profit and loss, as well as the amount of commissions, fees and other costs involved?

62. What other kinds of disclosures, if any, might be appropriate concerning, for example, potential conflicts of interest, the dealer's policies on helping end-users to unwind transactions and matters such as the dealer's financial soundness, experience, or track record?

63. Should dealers be required to make periodic status reports to end-users concerning the status of their OTC derivatives positions (*e.g.*, value, profits and losses)? If so, what kind of reports should be required, and how often should such reports be made?

64. Should dealers be required to collect information concerning their end-user customers? If so, what kind of information? Should dealers be required to retain documentation in their files concerning such information, and if so, what kind of documentation (*e.g.*, confirming that particular information has been collected and reviewed by management to assure transactions are in conformity with the end-user's investment goals and policies)?

65. What sales practice rules, if any, should apply to transactions where a dealer is acting as an agent or broker to facilitate a principal-to-principal transaction between two end-users? Similarly, what sales practice rules, if any, should apply to dealer-to-dealer transactions where both dealers are trading for their own proprietary accounts?

66. Should dealers have to comply with different sales practice standards in dealing with end-users having different levels of sophistication, based, for example, or portfolio size, investment experience, or some other measure? If so, please elaborate.

67. Should dealers be required to follow any supervision requirements in connection with the activities of sales personnel and other employees responsible for handling the accounts of end-user customers? Should complex or highly leveraged transactions require prior approval by senior management of the dealer?

68. What is the appropriate regime for formulating and overseeing the implementation and enforcement of possible sales practices rules, including the appropriate roles of the Commission, other financial regulators and industry self-regulatory bodies?

9. Recordkeeping

The Commission has not required any recordkeeping requirements for OTC derivatives dealers or other OTC market participants. Having retained authority over fraudulent and manipulative behavior in the OTC derivative market, the Commission wishes comment on whether some recordkeeping requirements would facilitate its exercise of that authority. Provisions requiring the retention of written records of transactions with counterparties, for example, might be considered. The Commission requests comment on whether there should be specific recordkeeping requirements for transactions in the OTC derivatives markets and, if so, what types of records should be kept and by whom.

Request for comment. 69. Are recordkeeping requirements for participants in the OTC derivatives markets needed? If so, what records should be required? Who should be required to keep them?

10. Reporting

The Commission currently does not impose reporting requirements on OTC derivatives market participants.[88] The

and systemic risk. See CFTC OTC Derivatives Report at 112–122. It may also be appropriate to consider whether to require dealers to disclose to prospective end-users other material information concerning OTC derivatives transactions, such as the relationship of the parties, the material terms of the contract, periodic reports of the status of the end-user's account, information on how the value of the OTC derivatives instrument would be affected by changes in the markets for the underlying components, and other similar information.

[87] 17 CFR 35.1(b)(2) (1997).

[88] The DPG has established voluntary reporting requirements. See DPG Framework at 23–25. The DPG has committed to regular periodic reporting and to respond in good faith to ad hoc requests for additional information by the CFTC. Id. at 1. The DPG member firms currently provide to the Commission on a quarterly basis a report detailing for each member except Credit Suisse First Boston: (1) a Credit-Concentration Report listing (on a ''no-names'' basis) the top 20 OTC derivatives exposures and, for each exposure, the internal credit rating, the industry segment, the current net exposure, the next replacement value, the gross replacement values (receivable and payable) and the potential additional credit exposure (at a ten-day, 99-percent confidence interval); (2) a Portfolio Summary

Commission requests comment on whether specific reporting requirements for participants in the OTC derivatives markets are needed and, if so, what reports should be made and by whom. If the Commission were to establish reporting requirements, it would coordinate with other regulatory agencies and, to the extent possible, accept reports provided to other regulatory agencies in satisfaction of the Commission's requirements. The Commission solicits comment concerning how these goals might best be accomplished.

Request for comment. 70. Should the Commission establish reporting requirements for participants in the OTC derivatives markets? If so, what information should be reported? By whom?

C. Self-Regulation

Having identified areas in which current exemptions might be modified, the Commission is also interested in the views of commenters concerning whether, and to what extent, any needed changes concerning the oversight of the OTC derivatives market could be accomplished through initiatives of industry bodies either voluntarily or through a self-regulatory organization empowered to establish rules and subject to Commission oversight. The Commission notes that several industry organizations already exist with an interest in maintaining and improving the integrity of the OTC derivatives marketplace. These organizations include, among others, the Derivatives Policy Group, the International Swaps and Derivatives Association, the Group of Thirty, and the End-Users of Derivatives Association. Industry groups have already issued a number of voluntary initiatives aimed at reducing risks and promoting stability and integrity in the OTC derivatives marketplace.[89] The Commission is interested in exploring the extent to which concerns described in this release might be addressed, and adequate oversight of the OTC derivatives marketplace might be attained, through industry bodies or through self-regulatory organizations.

Request for comment. 71. How effective are current self-regulatory efforts? What are their strengths and weaknesses?

72. Are there particular areas among those discussed above where self-regulation could obviate the need for government regulation?

73. Please discuss the costs and benefits of existing voluntary versus potential mandatory self-regulatory regimes.

74. If a self-regulatory regime were adopted, what mechanism would best assure effective oversight by the Commission?

75. How best can the Commission achieve effective coordination with other regulators in connection with the oversight of the OTC derivatives market?

IV. Summary of Request for Comment

Commenters are invited to discuss the broad range of concepts and approaches described in this release. The Commission specifically requests commenters to compare the advantages and disadvantages of the possible changes discussed above with those of the existing regulatory framework. In addition to responding to the specific questions presented, the Commission encourages commenters to submit any other relevant information or views.

Issued in Washington, D.C. this 6th day of May, 1998, by the Commodity Futures Trading Commission.

By the Commission (Chairperson BORN, Commissioners TULL and SPEARS; Commissioner HOLUM dissenting).

Jean A. Webb,

Secretary of the Commission.

Dissenting Remarks of Commissioner Barbara Pedersen Holum, Concept Release, Over-the-Counter Derivatives

In Section 4(c)(1) of the Commodity Exchange Act, Congress authorized the Commission to exempt certain transactions ''[i]n order to promote responsible economic or financial innovation and fair competition.'' Indeed, it appears that the dramatic growth in volume and the products offered in the OTC derivatives market may be attributed in part to the Commission's past exemptive action. In the spirit of the Commission's ongoing regulatory review program, it is appropriate to examine the continuing applicability of the existing exemptions, focusing on the expanding economic significance of the OTC market. However, in my judgement,the release goes beyond the scope of regulatory review by exploring regulatory areas that may be inapplicable to an OTC market. Accordingly, I am dissenting from the majority's decision to issue the Concept Release on OTC Derivatives in its current form.

Dated: May 6, 1998.

Barbara Pedersen Holum,

Commissioner.

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listing, by credit rating category and industry segment, the current net exposure, net replacement value, and gross replacement values; (3) a Geographic Distribution listing, by country, the current net exposure, the net replacement value, and the gross replacement values; (4) a Net Revenues Report listing, by product category and month, the net revenue; and (5) a Consolidated Activity Report listing, by product category, the aggregate notional amount.

[89]See, e.g.: Framework for Voluntary Oversight, supra; Principles and Practices for Wholesale Financial Market Transactions, supra; and Global Derivatives Study Group, Group of Thirty, Derivatives: Practices and Principles, supra.

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Food and Drug Administration

21 CFR Parts 430, 431, 432, 433, 436, 440, 441, 442, 443, 444, 446, 448, 449, 450, 452, 453, 455, and 460

[Docket No. 98N–0211]

Removal of Regulations Regarding Certification of Antibiotic Drugs; Companion Document to Direct Final Rule

AGENCY: Food and Drug Administration, HHS.

ACTION: Proposed rule.

SUMMARY: The Food and Drug Administration (FDA) is publishing this companion proposed rule to the direct final rule, published elsewhere in this issue of the **Federal Register**, which is intended to repeal FDA's regulations governing certification of antibiotic drugs. The agency is taking this action in accordance with provisions of the Food and Drug Administration Modernization Act of 1997 (FDAMA). FDAMA repealed the statutory provision in the Federal Food, Drug, and Cosmetic Act (the act) under which the agency certified antibiotic drugs. FDAMA also made conforming amendments to the act.

DATES: Comments must be received on or before July 27, 1998.

ADDRESSES: Submit written comments to the Dockets Management Branch (HFA–305), Food and Drug Administration, 12420 Parklawn Dr., rm. 1–23, Rockville, MD 20857.

FOR FURTHER INFORMATION CONTACT: Wayne H. Mitchell or Christine F. Rogers, Center for Drug Evaluation and Research (HFD–7), Food and Drug Administration, 5600 Fishers Lane, Rockville, MD 20857, 301–594–2041.

SUPPLEMENTARY INFORMATION:

I. Background

As described more fully in the related direct final rule, section 125(b) of FDAMA (Pub. L. 105–115) repealed section 507 of the act (21 U.S.C. 357)