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August 7, 2000

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COMMENT

Ms. Jean A. Webb
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1125 21st Street, N.W.
Washington, D.C. 20581

Re: Regulatory Reinvention, 65 Fed. Reg. 38985 (June 22, 2000)
Clearing Organizations Reinvention, 65 Fed. Reg. 39027 (June 22, 2000)
Exemption for Bilateral Transactions, 65 Fed. Reg. 39033 (June 22, 2000)

Dear Ms. Webb:

The California Power Exchange ("CalPx") appreciates the opportunity to offer these comments on the above-referenced proposals. We wish to commend the Commodity Futures Trading Commission ("CFTC" or "Commission") on its forward looking initiative to modernize regulation of the commodity futures markets in a manner intended to promote innovation in the development of trading facilities and competition among such facilities. At the same time, CalPx is concerned that the proposals are too restrictive in certain respects, as explained below.

CalPx was created in 1996 by the California legislature as a key part of its deregulation program for California's investor-owned electric utilities. CalPx offers physical delivery cash forward markets ("Day-Of," "Day-Ahead," "Block Forward" and others) for the purchase and sale of electricity between commercial parties, including California's largest utilities.¹ CalPx is regulated by the California Electricity Oversight Board and the Federal Energy Regulatory Commission.

¹ CalPx provides the Block Forward market pursuant to a December 16, 1999 no-action letter from the CFTC Division of Trading & Markets.

COMMENTS

CalPx generally supports the Commission's proposal to replace its outmoded "one size fits all" framework for regulating exchanges with a more flexible three-tiered approach where the degree and manner of regulating centralized derivatives markets will vary depending upon the sophistication of the market users and product characteristics. Two of these categories, recognized futures exchanges ("REFs") and derivatives transaction facilities ("DTFs"), would be regulated by the CFTC, under core principles that would replace the detailed requirements that apply today to futures exchanges. CalPx believes that this change in emphasis towards flexible, performance-based standards is a positive development, and is critical to achieve the CFTC's objective to transform itself into an oversight agency. The third tier is perhaps the most significant in that it would exempt from virtually all requirements of the Commodity Exchange Act and CFTC rules certain centralized markets that are eligible for classification as an exempt multilateral transaction execution facility ("Exempt MTEF"). The Commission should be commended for recognizing that there are centralized markets which are solely commercial or institutional that can and should be allowed to function without CFTC regulation.

CalPx believes that the three-tiered approach will lead to innovation in the development of market facilities by lowering the barriers of entry for prospective new exchanges and providing trading facilities with the flexibility to choose the regulatory categories in which to operate their markets. CalPx may soon consider whether to offer markets in energy-based derivatives as a natural complement to its existing cash forward markets, and the costs and regulatory burdens associated with becoming a licensed futures exchange, *i.e.*, a "designated contract market," under the existing regulatory framework are of particular concern. We believe the Commission's proposals, if adopted, will provide regulatory flexibility and decrease regulatory costs, which will attract new exchange entrants, leading to increased competition among alternative markets to the benefit of public consumers and the economy.

We are concerned, however, that the product restrictions for Exempt MTEFs are too restrictive. Specifically, we recommend that the Commission expand the range of derivatives that may be traded on an Exempt MTEF to include cash-settled and physical delivery derivatives based on electricity or other energy-based commodities, for two primary reasons.²

First, there are no customer protection reasons for precluding trading of energy derivatives on Exempt MTEFs, given that participation in Exempt MTEF markets would be limited to

² Trading facilities could, conceivably, offer cash-settled index contracts as Exempt MTEFs on a range of underlying commodities including energy under proposed Rule 36.2(b)(7). However, the Commission is proposing such restrictive design limitations to qualify under that product category as to render it virtually meaningless. Specifically, the Commission is proposing that a cash-settled contract be based on "an economic or commercial index or measure beyond the control of the counterparties to the transaction and not based upon prices derived from trading in a directly corresponding underlying cash market." [Proposed Rule 36.2(b)(7)] CalPx believes it would be extremely difficult, if not impossible, to design a cash-settled energy derivative that would be a useful risk management tool under those limitations.

institutional parties. The sophistication of the market participants should be the primary driving factor for determining exempt status. CalPx's commercial traders -- the very traders most like to use any exempt electricity-based derivatives we might offer -- are highly sophisticated and do not require the Commission's assistance to protect their interests. Excluding energy-based contracts from the Exempt MTEF category limits their future choice of risk-management venues while providing little, if any, concomitant benefit in the way of customer oversight protection.

Second, the change we recommend would open the way for the centralized clearing of exempt energy derivatives transactions. A key feature of the Commission's proposal -- and one we fully endorse -- is to allow clearing of transactions executed on an Exempt MTEF. As the Commission itself has found:

"Clearing organizations perform valuable functions in exchange-traded futures and option markets. They serve to mitigate counterparty credit risk, facilitate the netting and offsetting of contractual obligations, and decrease systemic risk. The development of similar clearing facilities for the clearing of over-the-counter-derivatives should be encouraged." 65 Fed. Reg. 39028.

CalPx agrees with the Commission that clearing should be encouraged for exempt (OTC) markets. The Commission, however, has generally restricted clearing as a condition of its exemptive orders and no-action rulings for the energy markets. In our view, the most direct way under the Commission's proposed framework to encourage the development of clearing for exempt energy derivatives transactions is to permit those transactions to take place on Exempt MTEFs.³

On a separate matter, we recommend that the Commission conform the terminology and definitions in the rules for DTEFs, on the one hand, and Exempt MTEFs and exempt Part 35 transactions, on the other, for the concept of "eligible participants." The Commission is proposing to use the term "eligible commercial participant" in the case of DTEFs, and to define that term more narrowly than the corresponding term "eligible participant" used in the case of Exempt MTEFs and Part 35 transactions, in two notable ways. First, eligible commercial participants have to meet a special commercial line of business test that eligible participants do not. Second, investment companies, commodity pools and benefit plans can be eligible participants but are not allowed to be eligible commercial participants.

It does not make sense to use a different term and narrower definition in the case of DTEFs, which are subject to CFTC regulation under core principles, than in the case of Exempt MTEFs and Part 35 transactions, which are not. The use of inconsistent terms merely adds

³ Alternatively, the Commission should consider, at a minimum, incorporating a procedure that allows Exempt MTEFs to seek CFTC permission to list other exempt products on a case-by-case basis. This would be similar to the procedure in the Part 37 rules for expanding the product restrictions for DTEFs.

unnecessary complication to the Commission's new framework. Thus, we recommend that the Commission substitute the term "eligible participant" for the term "eligible commercial participant" in the Part 37 rules for DTEFs and use the same definition it is proposing for Exempt MTEFs and Part 35 transactions in Rule 35.1(b) (which is cross referenced in the Part 36 rules for Exempt MTEFs).

CalPx also recommends reducing the total asset requirement for category (6) in the Rule 35.1(b) definition of eligible participant, which covers corporations, partnerships and other types of entities not formed solely for the purpose of being an eligible participant from total assets exceeding \$10 million to total assets exceeding \$5 million. The energy markets covered by the Commission's 1993 exemptive order have followed the lower \$5 million test without incident. This experience supports reducing the total assets test to \$5 million.

CalPx has several comments to offer with respect to the proposed Part 39 framework for clearing organizations. First, as explained above, CalPx fully supports the Commission's objective to encourage the development of clearing facilities for OTC transactions. The proposal to treat clearing as a standalone function, rather than an adjunct to exchange operations, is central to achieving this objective. Consistent with this objective, we also agree that the scope of the Part 39 rules should apply to clearing of exempt transactions that occur on an Exempt MTEF or under Part 35, as provided in Rule 39.1(b), but recommend expanding the provision to also include transactions under other CFTC exemptions.

Finally, we wish to confirm our reading of the Part 39 rules as they relate to the status of exempt transactions cleared by RCOs under the Commission's Part 190 bankruptcy rules. It is our understanding that under the Part 39 rules RCOs would be considered "designated contract markets" including for purposes of clearing exempt transactions. We read those provisions, in conjunction with proposed Rule 39.5 on enforceability -- which expressly identifies Part 190 as continuing to apply -- to mean that exempt transactions would be covered by the Part 190 bankruptcy rules if they are cleared by an RCO. CalPx fully supports this outcome as essential to the development of clearing facilities. CalPx encourages the Commission to retain this feature in the final rules, and to clarify the applicability of the Part 190 bankruptcy rules to exempt transactions cleared by an RCO.

CONCLUSION

The Commission's proposals are truly progressive and earn the title "regulatory reinvention." The three-tiered framework for trading facilities will encourage the development of trading facilities by lowering entry barriers and providing choices in how energy markets are structured and regulated. We are also pleased that the Commission is promoting the well-established benefits of clearing OTC markets, and we urge the Commission to give the OTC energy markets the same opportunity to develop clearing facilities for energy derivatives transactions.

CalPx urges the Commission to move expeditiously to adopt final rules, with the changes recommended above. We would be happy to discuss our comments with CFTC staff.

Respectfully submitted,

CALIFORNIA POWER EXCHANGE



Scott D. Rasmussen

General Counsel and Corporate Secretary