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August 7, 2000  
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Ms. Jean A. Webb  
Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, N.W.  
Washington, D.C. 20581

Re: Proposed Rules for a New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations and an Exemption for Bilateral Transactions

Dear Ms. Webb:

Merrill Lynch & Co. Inc. ("ML & Co.") is pleased to submit these comments in response to the Commodity Futures Trading Commission's (the "Commission") request for comments on the proposed rules for regulatory reform (the "Proposed Rules"). 65 Fed. Reg. 38986-39039 (June 22, 2000). The Proposed Rules include proposals for (i) A New Regulatory Framework for Multilateral Transaction Execution Facilities; (ii) Rules Relating to Intermediaries of Commodity Interest Transactions; (iii) A New Regulatory Framework for Clearing Organizations; and (iv) an Exemption for Bilateral Transactions.

ML & Co. Inc. provides investment, financing, insurance, and related services to individuals and institutions on a global basis through its broker, dealer, banking,

insurance, and other financial services subsidiaries. Services provided to clients by ML & Co. Inc. and subsidiaries (collectively, "Merrill Lynch") include securities brokerage, trading, and underwriting; dealing and brokerage of futures, options, forwards, swaps, and other derivatives; investment banking and other corporate finance advisory activities; asset management and other investment advisory and related services; banking, trust, and lending services; and insurance sales and underwriting services.

At the outset, Merrill Lynch wishes to commend the efforts of the Commission and its staff in developing regulatory reform proposals which represent a significant departure from the Commission's traditional approach to regulation of the markets and market participants. As a general matter, we strongly endorse the Commission's proposals as they would affect over-the-counter financial derivative products and the exchange markets. In that connection, Merrill Lynch is a member of the Ad Hoc Coalition of Commercial and Investment Banks and the Futures Industry Association, has participated in their discussions relating to these issues, and supports the positions taken by these groups on the Proposed Rules.

We believe, however, that certain aspects of the Proposed Rules relating to the New Regulatory Framework for Multilateral Transaction Execution Facilities would have an adverse impact on over-the-counter trading in energy and related products and we object to various elements of this proposal on that basis. For the reasons discussed, we believe that imposing additional regulation by the Commission on these developing markets would serve no useful policy or purpose under the Commodity

Exchange Act, as amended (the "Act"), 7 U.S.C. § 1 et seq. and would be at odds with the stated objectives of the Proposed Rules -- which are to promote financial innovation, assure that U.S. markets remain competitive in a rapidly evolving global marketplace, reduce systemic risk, and enhance legal certainty.

## I. Introduction

In general, Merrill Lynch supports the Commission's intention to move away from direct regulation and toward functioning primarily in an oversight role. We also support the Commission's recognition of the increasing convergence of exchange and over-the-counter markets, as well as the rapid expansion of electronic trading, and of the consequent need for a new regulatory framework that is responsive to these developments. The Commission and its staff deserve a great deal of praise for this rulemaking initiative. These comments are designed to assist in the formulation of final rules which address over-the-counter trading in energy and related products in a manner consistent with the Commission's stated objectives.

## II. Exemption for Bilateral Transactions

The Commission is proposing to amend the Part 35 swaps exemption to expand and clarify its scope in a number of ways. First, it is proposing to delete any specific reference to "swap agreements" within the exemption itself, so that the rules would refer to any "contract, agreement or transaction" that meets the required exemptive criteria. Second, it is proposing to delete the current requirement that exempt transactions not be fungible or standardized and is making clear that, insofar

as such exempt transactions may be cleared, individualized counterparty credit risk assessment is not a criterion for the exemption. Third, it is clarifying that the use of an electronic or non-electronic market or similar facility used solely to communicate bids or offers by market participants or the use of such a market or facility by a single counterparty to offer to enter into or enter into bilateral transactions with multiple counterparties is permissible under the exemption. In addition, it is proposing, through an exemption from the private right of action provision of Section 22 of the CEA, that transactions entered into pursuant to the Part 35 swaps exemption would not be subject to repudiation due solely to a violation of the exemption's requirements.

The Commission is also proposing to incorporate by reference the 1989 Swaps Policy Statement as Appendix A to Part 35 and thereby confirm its continuing validity. Finally, the Commission is reaffirming the continuing applicability of its Statutory Interpretation Concerning Forward Contracts and the energy contract exemption. See CFTC Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30694 (July 21, 1989); Statutory Interpretation Concerning Forward Contracts, 55 Fed. Reg. 39188 (September 25, 1990) (the "Statutory Interpretation"); Exemption for Certain Contracts Involving Energy Products, 58 Fed. Reg. 21286 (April 20, 1993) (the "Energy Contract Exemption").

We generally support these proposals as likely to provide greater legal certainty for swap and similar transactions under the Act. In particular, we believe that the Commission's proposal to preclude counterparties from repudiating their obligations under these transactions solely on the basis of a violation of the

exemption's requirements will enhance legal certainty and thereby contribute to reducing systemic risk in these markets. For these reasons we urge the Commission to provide a similar exemption from Section 22 of the Act for transactions entered into pursuant to the Statutory Interpretation.<sup>1</sup>

We wish to note that the Part 35 Rules and the proposed amendments thereto do not condition eligibility for the exemption based upon the nature of the commodity underlying swap transactions, e.g., whether the underlying commodity has an inexhaustible supply. Nor are we aware of any problems having occurred since the adoption of the Part 35 Rules in 1993 relating to the type of commodity underlying swap transactions which have been exempted from regulation.

Merrill Lynch also welcomes the Commission's affirming the continued applicability of the Statutory Interpretation and the Energy Contract Exemption. As the Commission is aware, energy market participants have relied on the forward contract exemption as construed by the Commission in the Statutory Interpretation since 1990 and the Energy Contract Exemption since 1993 without regard to whether the underlying commodities involved in these transactions have an inexhaustible supply.<sup>2</sup>

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<sup>1</sup> The Commission is proposing to provide a similar exemption from Section 22 of the Act for transactions entered into pursuant to the Swaps Policy Statement and the Statutory Interpretation Concerning Hybrid Instruments.

<sup>2</sup> On a related point, we believe that it would be useful for the Commission to confirm that market participants may rely on the Energy Contract Exemption to enter into bilateral electricity forward transactions, subject to complying with the requisite criteria for this exemption.

### III. Regulatory Framework for Multilateral Transaction Execution Facilities

The Commission is proposing three new regulatory tiers for markets: recognized futures exchanges, recognized derivative transaction facilities, and exempt multilateral transaction execution facilities. The category with the least regulatory oversight would be an Exempt Multilateral Transaction Execution Facility (an “MTEF”). The Commission is proposing to define an MTEF in Rule 36.1(b) as

an electronic or non-electronic market or similar facility through which persons ... enter into, agree to enter into or execute binding transactions by accepting bids or offers made by one person that are open to multiple persons conducting business through such market or similar facility.

#### A. Exempt MTEF Category

This category would be limited to markets with transactions only among eligible participants as defined (i.e., institutional participants trading for their own account(s) or through another eligible institutional participant) and only involving contracts based upon specified commodities that have an inexhaustible supply or have no underlying cash market, including a debt obligation, foreign currency, an interest rate, an exempt security or an index thereof, a measure of credit risk or quality, an economic or commercial index or measure, or based on an occurrence or contingency beyond the control of the counterparties, e.g., weather. Thus, over-the-counter trading

in energy products, even if entered into solely between commercial participants, could not occur on an exempt MTEF under the proposed Part 36 Rules.

Although an exempt MTEF generally would be exempt from regulation under the Act and Commission rules and regulations and could not hold itself out as being regulated by the Commission, it would be subject to antifraud and antimanipulation provisions and a requirement that, if performing a price discovery function, it provide pricing information to the public “appropriate to that market.” As with the Part 35 Rules, a violation of the terms of the Part 36 Rules would not render any transactions effected on an exempt MTEF void.

#### B. Recognized DTF Category

Under the proposed Part 37 Rules, over-the-counter trading in energy products could occur on a recognized derivatives transaction facility (a “DTF”) which would be subject to an intermediate level of regulatory oversight by the Commission. A DTF would be limited to trading the same commodities available for trading on an exempt MTEF as well as other commodities on a case-by-case basis if non-commercial participants may trade. If only commercial participants may trade, a DTF could trade any commodity, other than specified agricultural commodities.<sup>3</sup>

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<sup>3</sup> For this purpose, the definition of “eligible commercial participant” proposed in Rule 37.1(b) includes (i) certain categories of entities (A) who are eligible to enter into exempt transactions under Part 35 and (B) who in connection with their business, make and take delivery of the underlying physical commodity and regularly incur risk related to such commodity, or (ii) a dealer that regularly provides hedging, risk management or market-making services to the foregoing entities.

As proposed, a DTF would be required to meet certain conditions for recognition, including: the establishment of rules to deter trading abuses or use of technology that provides participants with impartial access to transactions and captures information that is available for determining whether violations of its rules have occurred; rules or terms and conditions explaining the operation of the trading mechanism or electronic matching platform; and rules or terms and conditions detailing the financial framework or ensuring the financial integrity of transactions. A DTF also would be required to meet and adhere to seven core principles relating to: enforcement, market oversight, operational information, transparency, fitness, recordkeeping, and competition.

### C. Over-the-Counter Trading in Energy Products

Given the time, expense, and lack of certainty involved, we believe that individualized requests for staff no-action letters or exemptive relief pursuant to Section 4(c) cannot adequately address the needs of our business. The result will be to stifle or delay innovation in the energy markets, with consequent market inefficiencies and distortions. We therefore urge the Commission to reconsider and modify the proposed treatment of over-the-counter markets in energy and related products in accordance with the following.

#### (1) Exempt MTEF Category

We believe that the final rules should reflect that over-the-counter trading in energy or related products between commercial entities may appropriately



occur on an exempt MTEF. We note that over-the-counter bilateral trading in energy products between commercial entities has been exempted from all but the antimanipulation provisions of the Act since 1993 pursuant to the Energy Contract Exemption and that no pattern of abuses or irregularities has been identified which would warrant precluding trading in energy products from occurring on an exempt MTEF, where participation is confined to commercial entities. To our knowledge over-the-counter trading in energy products, whether in the form of swaps, forward contracts, options, or other hybrid products, has not had any adverse impact on regulated futures trading involving energy products. Mere assertions about a potential adverse impact should not form a basis for rulemaking by the Commission, especially in light of the empirical evidence to date which indicates that alternative trading markets for energy products bring volume and liquidity to the regulated futures markets. The Commission's expressed concern that transactions in energy products on an MTEF may be susceptible to manipulation and may have an adverse impact on regulated energy futures trading would be addressed in that transactions on an exempt MTEF would remain subject to the antimanipulation, as well as the antifraud, provisions of the Act pursuant to Rules 36.2 and 36.3(a), as proposed. In addition, the proposed blanket exclusion of trading in energy products from occurring on an exempt MTEF would disregard the applicability of other regulatory schemes to such transactions, where alternative regulation does exist, as described below.

(2) Recognized DTF Category

As proposed, trading in energy products between commercial entities could occur on a DTF. However, we find the DTF category to be overly prescriptive and insufficiently flexible to accommodate evolving over-the-counter markets in energy products as they migrate to multilateral electronic trading platforms.

First, the recognition process for a DTF resembles far too closely the contract market designation application process for a traditional futures exchange. Instead, we recommend that a DTF which limits participation to eligible commercial entities be permitted to begin trading upon filing a submission with the Commission containing specified certifications or representations. Second, the conditions for recognition should be substantially modified where the trading platform limits participation to eligible commercial entities. In such a case it should be sufficient that the trading platform submit the terms and conditions governing trading, provide assurance of fair, non-discriminatory access to prospective participants meeting its admissions criteria, certify that the owners or sponsors of the facility would not be statutorily disqualified from registration under Section 8a(2) of the Act, make and keep records of trading conducted on the facility, and agree to provide information to the Commission about such transactions upon request. We also would not object to a transparency requirement if the facility is a significant source of price discovery for cash market transactions in the underlying commodity and the transactions conducted on the facility constitute futures contracts or options on futures contracts.

Moreover, where other regulation exists, the Commission should accept the applicability of an alternative regulatory framework in satisfaction of the proposed conditions and core principles for a DTF, whether participation is limited to eligible commercial entities or non-commercial participants may trade through an intermediary. Unlike other aspects of the Proposed Rules and past action by the Commission involving hybrid products, the Part 37 Rules do not reflect that trading conducted on a DTF may be subject to oversight under another body of law and provide for Commission deference to such oversight.<sup>4</sup> By way of example, the emergence of “power pools” and “power exchanges” through which electricity is sold on a regional basis is a direct result of actions taken by the Federal Energy Regulatory Commission (the “FERC”) pursuant to federal law to promote the development of a competitive market for wholesale electrical power in the United States. See, e.g., 16 U.S.C. § 824a-1, 15 U.S.C. § 79z-5a and 16 U.S.C. § 796 (22-25), 824j-1; Order No. 888, Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities and Recovery of Standard Costs by Public Utilities and Transmitting Utilities, 61 Fed. Reg. 21540 (May 10, 1996); Order No. 2000, Regional Transmission Organizations 89 FERC ¶ 61,285 (December 20, 1999). At the same time as the FERC has been taking steps to introduce competition at the wholesale level, a number of states have taken action to bring the benefits of competition to the retail consumer. These efforts have also encouraged the

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<sup>4</sup> The Commission previously has deferred to other applicable regulatory frameworks in connection with adopting a non-exclusive safe harbor and an exemption for hybrid products. See Statutory Interpretation Concerning Hybrid Instruments, 55 Fed. Reg. 13582 (April 11,

establishment of trading platforms on which electrical power can be bought and sold. Consistent with the evolution of this market, major market participants have been developing standardized forms of contract and codes of best practices with widespread industry input.

While competitive market forces are driving the current evolution in the market for electric power, electricity trading remains subject to oversight by the FERC and the states, including licensing standards for market participants, reporting requirements, and enforcement authority to remedy any problems that may arise. For example, when electricity prices in the Midwest dramatically increased to several thousand dollars per MWH for a brief period during the late spring and early summer of 1998, the FERC conducted an investigation of these events and concluded that the price spikes were not due to price manipulation but to an unusual confluence of factors and therefore highly unlikely to recur. See A Staff Report to the FERC on the Causes of the Pricing Abnormalities in the Midwest During June 1998. Although the FERC did not in that instance elect to take any remedial action such as imposing a price cap, its statutory authority to do so is clear.<sup>5</sup> In light of the foregoing, any extensive requirements for recognition as a DTF would likely be duplicative of, and potentially

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1990); Regulation of Hybrid Instruments, 58 Fed. Reg. 5580 (January 22, 1993) (adoption of the Part 34 rules).

<sup>5</sup> More recently, the FERC adopted an order directing its staff to investigate factors affecting competition and market price fluctuations in electric bulk power markets in light of “rapidly changing markets and market price volatility” and to report to it by November 1, 2000. Once it has the information, FERC will determine “whether bulk power markets are working efficiently and, if not, the underlying cause” and what steps to take “to remedy any market behavior, operation, design or structural problems” to “assure well functioning markets.”

inconsistent with, those requirements that the FERC or state public utility commissions already have imposed.

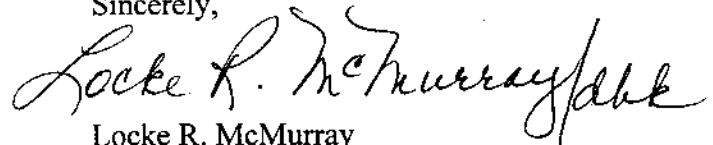
As with electric power, the emergence of a robust market for natural gas has been fostered by federal legislation and actions taken by the FERC to promote open access to transmission grids for natural gas. See, e.g., 15 U.S.C. § 3431(b)(1)(A); Order No. 636, Pipeline Service Obligation and Revisions to Regulations Governing Self-Implementing Transportation, and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 57 Fed. Reg. 13267 (April 16, 1992); Order No. 637, Regulation of Short-Term Natural Gas Transportation Services, and Regulation of Interstate Natural Gas Transportation Services (February 9, 2000). Similarly, many state legislatures and public utility commissions have followed suit by adopting rules to facilitate or require the unbundling of gas distribution from production and supply. As with developments in the electricity market, a standardized form of contract developed by major market participants with industry input is in widespread use in the natural gas market. Given this statutory background, it would be inconsistent with the intent of Congress and actions taken by the FERC for the Commission to impose additional regulation on natural gas trading.

#### IV. Conclusion

Subject to the comments and recommendations set forth in this letter, we encourage the Commission to adopt the Proposed Rules. Merrill Lynch believes that adoption of the Proposed Rules, together with the modifications discussed to accommodate over-the-counter markets in energy and related products, will go a long

way toward accomplishing the Commission's stated objectives and will be in public interest. We appreciate the opportunity to submit our views and would be pleased to assist the Commission and its staff as they proceed with this rulemaking initiative. If the Commission or its staff has any questions concerning the matters discussed in this letter, please do not hesitate to contact the undersigned at (212) 449-6352.

Sincerely,

A handwritten signature in black ink that reads "Locke R. McMurray". The signature is written in a cursive style with a large, stylized initial "L".

Locke R. McMurray  
Director and Senior Counsel

cc: Honorable William J. Rainer  
Honorable Barbara Pederson Holum  
Honorable David D. Spears  
Honorable James E. Newsome  
Honorable Thomas J. Erickson  
C. Robert Paul, General Counsel  
John C. Lawton, Acting Director, Division of Trading and Markets  
John Mielke, Acting Director, Division of Economic Analysis  
Phyllis J. Cela, Acting Director, Division of Enforcement