Derivatives Regulation

Regulation of financial derivatives in the US code

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Practical applications

Derivative users operate in a regulated environment. Restrictions on derivatives use are in Table 7 of the U.S. Code, which regulates commodity exchanges. Congress has historically increased the Commodity Futures Trading Commission's regulatory power but the CFTC's authority to regulate does not include certain financial derivatives.

Abstract

Most statutory references to financial derivatives are in Title 7 of the US Code, which regulates commodity exchanges. The Commodity Futures Modernization Act of 2000 was Congress's eleventh legislative act since it first regulated commodity markets in 1921. The 2000 Act excludes identified banking products, including covered swap agreements, from regulation by the Commodity Futures Trading Commission.

INTRODUCTION

Agricultural commodities and the sophisticated instruments known as financial derivatives may appear regulatory worlds apart, yet ancient and ultramodern are both addressed in Title 7 of the US Code, which regulates commodity exchanges.

The source of congressional power to regulate derivatives is the US Constitution's interstate commerce clause. Courts have interpreted Article I, Section 8, Clause 3 to mean that Congress has the power 'to regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes'. Congress found (7 USC, 5) financial derivatives, 'are entered into regularly in interstate and international commerce and are affected with a national public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities.'

Other purposes for congressional regulation are to serve 'public interests' through 'a system of effective self-regulation

of trading facilities, clearing systems, market participants and market professionals'. These include deterring and preventing price manipulation or other disruptions to market integrity; ensuring financial integrity; avoiding systemic risk; protecting market participants from fraudulent or other abusive sales practices and misuses of customer assets; and promoting responsible innovation and fair competition among boards of trade, other markets and market participants.

A BRIEF REGULATORY HISTORY

Congress has passed 11 acts since first regulating commodity markets. 19th century populist critics of futures markets¹ tried unsuccessfully to outlaw, rather than regulate, trading.² The first substantive congressional action, the Futures Trading Act (1921), was regulatory, but declared unconstitutional in two court decisions, *Hill v Wallace* (futures contract) and *Trassler v Crooks*. *Hill* dealt with futures and *Trassler* with options. The Act, based on Congress's power to levy taxes, was ruled unconstitutional on the grounds it imposed a penalty to seek compliance.³ Congress deleted the tax provisions and enacted the Grain Futures Act (1922), based on the Constitution's interstate commerce clause.⁴ The Act regulated exchanges, not individual traders. The Commodity Exchange Act (1936) increased the number of commodities subject to regulation and regulated traders. Amendments to the Commodity Exchange Act (1968) extended government regulation to additional commodities, including frozen concentrated

orange juice. A significant event occurred in 1974, with the passage of the Commodity Futures Trading Act. This Act extended regulation to all futures trading and created a federal regulatory agency for commodities trading comparable to the Securities and Exchange Commission (SEC). This new agency, the Commodity Futures Trading Commission (CFTC), retains exclusive jurisdiction over all commodity futures contracts, including options or futures. The SEC, by contrast, was given jurisdiction over 'options on securities, including groups of securities or indices based on the value of securities'.⁵ CFTC reauthorisation occurred in 1978 and in 1982 with the Futures Trading Act. Subsequent legislation includes the Futures Trading Act (1986), the Futures Trading Practices Act (1992), the CFTC Reauthorization Act (1995) and the Commodity Futures Modernization Act (2000). The 2000 Act reauthorised funding for the CFTC in the 2001–2005 period.

Congress has increased the CFTC's regulatory power throughout this historical process.

PURPOSE OF THE COMMODITY FUTURES MODERNIZATION ACT

Congress cited eight purposes for the 2000 Act.

- Reauthorising the CFTC's appropriation.
- Streamlining and eliminating unnecessary regulation.
- Transforming the CFTC's role to futures markets oversight.
- Establishing 'a statutory and regulatory

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- framework’ for allowing the trading of futures on securities.
 - Clarifying the CFTC’s ‘jurisdiction over certain retail foreign exchange transactions and bucket shops that may not be otherwise regulated’.
 - Promoting ‘innovation for futures and derivatives’ and reducing ‘systemic risk by enhancing legal certainty in the markets for certain futures and derivatives transactions’.
 - Reducing systemic risk and providing ‘greater stability to markets during times of market disorder by allowing the clearing of transactions in over-the-counter derivatives through appropriately regulated clearing organizations’.
 - Enhancing the ‘competitive position’ of US financial institutions and markets.

DEFINITIONS IN THE COMMODITY FUTURES MODERNIZATION ACT

The 2000 Act defines terms of interest to persons and institutions that use derivatives.

The term *person* includes individuals, associations, partnerships, corporations and trusts.

Registered entity includes a board of trade designated as a contract market, a derivatives transaction execution facility or a derivatives clearing organisation.

Derivatives clearing organisation is defined as ‘a clearinghouse, clearing association, clearing corporation, or similar entity, facility, system, or organization’ that:

- ‘enables each party to the agreement, contract, or transaction to substitute,

- through novation or otherwise, the credit of the derivatives clearing organization for the credit of the parties;
- ‘arranges or provides, on a multilateral basis, for the settlement or netting of obligations resulting from such agreements, contracts, or transactions executed by participants in the derivatives clearing organisation; or
- ‘otherwise provides clearing services or arrangements that mutualize or transfer among participants in the derivatives clearing organization the credit risk arising from such agreements, contracts, or transactions executed by the participants’.

Exclusions include ‘an entity, facility, system, or organization solely because it arranges or provides for:

- ‘settlement, netting, or novation of obligations resulting from agreements, contracts, or transactions, on a bilateral basis and without a central counterparty;
- ‘settlement or netting of cash payments through an interbank payment system; or
- ‘settlement, netting, or novation of obligations resulting from a sale of a commodity in a transaction in the spot market for the commodity’.

Excluded commodity means ‘(i) an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure; (ii) any other rate, differential, index, or measure of economic or

commercial risk, return, or value that is — (I) not based in substantial part on the value of a narrow group of commodities not described in clause (i); or (II) based solely on one or more commodities that have no cash market; (iii) any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction; or (iv) an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in clause (i)) that is — (I) beyond the control of the parties to the relevant contract, agreement, or transaction; and (II) associated with a financial, commercial, or economic consequence’.

A *hybrid instrument* is defined as ‘a security having one or more payments indexed to the value, level, or rate of, or providing for the delivery of, one or more commodities’.

EXCESSIVE SPECULATION

The 2000 Act gives the CFTC authority for ‘diminishing, eliminating, or preventing’ action defined as ‘excessive speculation in any commodity subject to the rules of contract markets or derivatives transaction execution facilities that cause ‘sudden or unreasonable fluctuations or unwarranted changes’ in price. The CFTC has the authority to exempt transactions such as spreads, straddles or arbitrage, or from fixing limits applying to such transactions or positions different from limits fixed for other transactions or positions. ‘Arbitrage’ in domestic markets means the same as ‘spread’

or ‘straddle’. The CFTC has the authority to define the term ‘international arbitrage’.

‘No rule, regulation, or order’ issued by the CFTC under the Act shall apply to transactions or positions which are shown to be *bona fide* hedging transactions. This exemption permits ‘producers, purchasers, sellers, middlemen, and users of a commodity or a product derived therefrom to hedge their legitimate anticipated business needs for that period of time into the future for which an appropriate futures contract is open and available on an exchange’.

PROHIBITED TRANSACTIONS

Wash sales, fictitious sales or transactions ‘used to cause any price to be reported, registered, or recorded that is not a true and *bona fide* price’ are prohibited under the 2000 Act.

CONSIDERATION OF COSTS AND BENEFITS

The CFTC is required to consider the costs and benefits of any proposed regulation. The costs and benefits shall be evaluated in the light of considerations of protection of market participants and the public; the efficiency, competitiveness and financial integrity of futures markets; price discovery; sound risk management practices; and other public interest considerations.

NOT APPLICABLE TO FOREIGN CURRENCY OPTIONS

The 2000 Act does not govern ‘any transaction in an option on foreign

currency traded on a national securities exchange’.

EXCLUSION OF IDENTIFIED BANKING PRODUCTS FROM CFTC REGULATION

The CFTC does not have the authority under the 2000 Act to regulate ‘an identified banking product’ if an appropriate banking agency certifies it was ‘commonly offered, entered into or provided’ in the USA by any bank on or before 5th December, 2000. The CFTC has no authority to regulate an identified banking product which had not been commonly offered, entered into or provided by any bank on or before the same date if ‘the product has no payment indexed to the value, level, or rate’, and does not provide for the delivery of any commodity.

Congress also prevented the CFTC from exercising regulatory authority with respect to a banking product if it is a hybrid instrument under the terms of a predominance test. A hybrid instrument is considered to be predominantly a banking product if the following conditions are met.

- The issuer of the hybrid instrument receives payment in full of the purchase price of the hybrid instrument substantially contemporaneously with delivery of the hybrid instrument.
- Under the terms of the instrument, or any arrangement referred to in the instrument, the purchaser or holder is not required to make any payment to the issuer in addition to the purchase price, whether as margin, settlement payment or otherwise during the life of

the hybrid instrument or at maturity.

- The issuer is not subject by the terms of the instrument to mark-to-market margining requirements.
- The hybrid instrument is not marketed as a contract of sale of a commodity for future delivery under federal law.

CONSULTATION WITH FEDERAL RESERVE

The CFTC is required to ‘consult with and seek the concurrence of the Board of Governors of the Federal Reserve System concerning the nature of the hybrid instrument before commencing a rulemaking or making a determination about any identified banking product’. The ‘history, purpose, extent, and appropriateness’ of any proposed regulation must be taken into consideration, given federal law. The Board of Governors may obtain a review of any CFTC rule or determination in the US Court of Appeals for the District of Columbia Circuit by filing ‘a written petition requesting that the rule or determination be set aside’ no later than 60 days after the date of publication. The Act requires the Court to expedite the proceeding.

EXCLUSION OF COVERED SWAP AGREEMENTS

The 2000 Act does not apply to covered swap agreements and the CFTC is prohibited from exercising regulatory authority with respect to a covered swap agreement offered, entered into or provided by a bank.

OTHER US CODE REFERENCES TO DERIVATIVES

Title 11 (Bankruptcy), Chapter 1 (101.53B), defines ‘swap agreement’ as:

- 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, spot 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);
- any combination of the foregoing; or
- a master agreement for any of the foregoing together with all supplements.’

Chapter 5 (3.560) describes the contractual right to terminate a swap agreement.

Title 26 (Internal Revenue Code), Chapter 1, examines normal taxes and surtaxes and general rules for determining capital gains and losses. Any ‘commodities derivative financial instrument held by a commodities derivatives dealer’ is excluded from the term ‘capital asset’ unless two conditions are met. First, it must be ‘established to the satisfaction of the Secretary that such instrument has no connection to the activities of such dealer as a dealer’. Secondly, the instrument must be ‘clearly identified in such dealer’s records

as being described in subparagraph (A) before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe)’.

CONCLUSION

The Commodity Futures Modernization Act of 2000 is the most significant federal legislation regulating financial derivatives since the Commodity Futures Trading Act of 1974. The 2000 Act strikes a regulatory balance by continuing US government oversight of the industry, while deregulating certain banking products, including covered swap agreements, from regulation by the Commodity Futures Trading Commission.

References

- (1) The first US political party to propose regulating commodities was the anti-alcohol Prohibition Party. Its 1892 platform stated, ‘Speculations in margins, the cornering of grain, money and products, and the formation of pools, trusts, and combinations for the arbitrary advancement of prices should be suppressed.’
- (2) Hieronymus, T. A. (1977) ‘Economics of Futures Trading for Commercial and Personal Profit’, Commodity Research Bureau, New York, NY.
- (3) Guttman, E. (1978) ‘The Futures Trading Act of 1978: The reaffirmation of CFTC–SEC coordinated jurisdiction over security/commodities’, *The American University Law Review*, Vol. 28, pp. 1–35.
- (4) Davis, R. J. (1981) ‘The Commodity Exchange Act: Statutory silence is not authorization for judicial legislation of an implicit private right of action’, *Missouri Law Review*, Vol. 46, pp. 316–336.
- (5) Connolly, J. P. (1983) ‘A review of the Futures Trading Act of 1982’, *Corporation Law Review*, Vol. 6, pp. 342–359.