US legal and regulatory developments

Validity of Commodity Futures Trading Commission's Policy Statement concerning swap transactions reaffirmed; CFTC Reauthorization Act of 2005

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VALIDITY OF COMMODITY FUTURES TRADING COMMISSION'S POLICY STATEMENT CONCERNING SWAP TRANSACTIONS REAFFIRMED

The Commodity Futures Trading Commission ('FTC') has reaffirmed its Policy Statement Concerning Swap Transactions ('Policy Statement')¹ in its recent ruling in *Khorram Properties, LLC v McDonald Investments, Inc.*²

Khorram Properties, LLC ('Khorram'), as Complainant, had paid a settlement payment to Key Bank National Association³ then subsequently sought to recover such payment by claiming that the interest rate swap was an illegal, off-exchange futures contract. The question before the CFTC was whether the Policy Statement was still in effect for, and whether it applied to, this interest rate swap transaction.

Khorram argued that swap agreements

may only be legally offered under Section 2(g) of the Commodity Exchange Act⁴ (the 'CEA') and Part 35 of the CFTC's Regulation. Further, Khorram argued that the Policy Statement was superseded by Section 2(g) and Part 35, because they were enacted after the Policy Statement. In addition, Khorram contended that it was neither an 'eligible swap participant' under Rule 35.1(b)(2) nor an 'eligible contract participant' under Section 1a(22) of the CEA. Therefore, it argued, the swap was illegal.

Section 2(g) was incorporated into the CEA by the Commodity Futures Modernization Act of 2000.⁵ The CFTC adopted Part 35 in January 1993 by virtue of the power granted to it by the US Congress to grant exemptions through a new Section 4(c), added to the CEA by the Futures Trading Practices Act of 1992

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(the 'FTPA').⁶ Specifically, the FTPA gave the CFTC general authority to grant exemptions that are in the public interest and do not directly address any specific type of transaction. The CFTC may not grant any exemptions under this section unless it has determined that the transaction or agreement will be entered into solely between 'appropriate persons'.

Years ago, the CFTC understood that certain regulatory uncertainties hindered the further development of the over-the-counter swap market. It therefore subsequently issued the Policy Statement in 1989 to create a safe harbour from regulation for cash settled swaps.

To benefit from the protection of the safe harbour, five conditions must be satisfied: (1) the material economic terms of the swap transaction must be individually tailored; (2) there must be no exchange-style offset; (3) there must be an absence of a clearing organisation or margin system; (4) the swap transaction must be entered into in conjunction with each party's lines of business; and (5) the transaction must not be marketed to the general public.⁷

McDonald maintained that (i) the Policy Statement remains in effect, (ii) the swap between the parties fulfilled the requirements of the Policy Statement, and (iii) 'qualifying swaps under the Policy Statement are not regulated as exchanged-traded futures, and therefore are not subject to the Commissioner's reparations jurisdiction under Section 14 of the Act'⁸.

The CFTC disagreed with the Complainant and held that the Policy Statement continues to be in effect, that all

the requirements of the Policy Statement had been fulfilled, and further ruled that the swap transaction was beyond its jurisdictional reach.

In its ruling, the CFTC set aside Khorram's argument that the Policy Statement was superseded by more recent legislative actions. The CFTC stated that the Policy Statement was never withdrawn and that the CFTC 'expressly reaffirmed it in its original terms in 1993 and 1998'.⁹ It continued as follows: 'In approving the Part 35 rules, the Commission stated that the Policy Statement would remain in effect and that swaps market participants could continue to rely upon it for existing and new swaps. ... The Commission reaffirmed the Policy Statement's viability five years later in the Concept Release. The Concept Release summarised the Policy Statement and reiterated that all applicable exemptions, interpretations, and policy statements issued by the Commission concerning over-the-counter derivative contracts remained in effect, and that market participants could continue to rely upon them.'¹⁰

Further, the CFTC also affirmed that '[the] treatment of swaps under the Commission's Part 35 rules is not at cross-purposes to the treatment of qualifying swaps under the Policy Statement. They are non-exclusive, complimentary sources of regulatory relief'.¹¹ The CFTC stated that whether or not the Complainant is an eligible swap participant under Part 35 or an eligible contract participant under Section 2(g) is irrelevant to the analysis. The Policy Statement is applicable in this case.

The CFTC also considered whether the swap agreement satisfied the conditions of the Policy Statement and concluded that the record showed that the Respondent had demonstrated that the transaction qualified. There was no disagreement between the parties as to three of the five elements of the Policy Statement. Khorram argued, however, that two of the requirements (that the transaction have individually tailored terms and that it not be marketed to the general public) had not been satisfied.

The Complainant maintained that the terms of the swap were not individually tailored because the parties had memorialised them on an ISDA form agreement and because both the notional amount and the interest rate were set by the market. The CFTC rejected these arguments as lacking merit. First, it stated that, in issuing the Policy Statement, the CFTC said that ‘individually tailored terms’ does not preclude the use of a master agreement, ‘provided the material terms of the master agreement and transactions specifications are individually tailored by the parties’.¹² In its ruling, the CFTC went on to state that the swap in question contained material individually tailored terms. The notional amount was tied to the amount of financing required by Khorram under a loan from KeyBank National Association, the settlement date was tied to the date it expected it would need permanent financing and the interest rate was based on a future settlement date that was specific to the Complainant. Secondly, the record showed that the Respondent only marketed swaps to its

commercial loan customers in connection with anticipated or closed loans. Finally, the CFTC stated that Khorram’s swap could not have been marketed to the public as it contained terms unique to its loan transaction.

Although it is only applicable in limited circumstances, it does provide a valuable safe harbour from regulation that may be applicable in circumstances where a counterparty is neither an ‘eligible swap participant’ nor an ‘eligible contract participant.’

CFTC REAUTHORIZATION ACT OF 2005

Unlike most other federal agencies, the CFTC’s authority is subject to termination unless it is reauthorised. The reauthorisation cycle has traditionally been four year (but may be longer), and each reauthorisation gives interested stakeholders the opportunity to introduce changes to the CEA. In connection with the last reauthorisation five years ago, the Commodity Futures Modernization Act of 2000 (CFMA) introduced the most substantive changes since the CFTC was created in 1974. This exercise in 2005 remedied certain regulatory issues that were left unresolved by the CFMA.

On 7th December, 2005, the House Committee on Agriculture approved by voice vote a Chairman’s Mark to reauthorise the CFTC. Seven days later, on 14th December, the House of Representatives passed the CFTC Reauthorization Act of 2005¹³ (the ‘Reauthorization Act’).

The Reauthorization Act seeks to (a) clarify the CFTC's authority over agreements, contracts and transactions in foreign currency, (b) expand the scope of the CFTC's antifraud authority to cover principals and not just their agents, (c) require the Securities and Exchange Commission (SEC) and the CFTC to take the necessary action to develop regulatory division of authority to permit risk-based portfolio margining for security options and security futures products by 30th September, 2006, and to permit the trading of futures on certain security indexes by resolving issues related to debt security indexes and foreign security indexes by 30th June, 2006, and (d) authorise appropriation for each of fiscal years 2006–2010.

In addition, the Chairman of the House Agriculture Committee, Bob Goodlatte (R-Va), offered an amendment to the Chairman's Mark that would direct the CFTC to undertake surveillance of trading in contracts for natural gas so as to detect and deter the manipulation and attempted manipulation, and increase the pricing transparency, of natural gas. In circumstances where there are significant and highly unusual price fluctuations in any physically delivered natural gas future traded on an exchange, the amendment would require the CFTC to conduct a review of the factors that caused such price movements in order to determine whether manipulation or attempted manipulation had occurred. In its review, the CFTC would consider a variety of factors, including: prices and price relationships in the future and cash markets, market

information and supply and demand factors, and large futures and options market positions. The amendment would charge the CFTC to adopt, by rule, a requirement that traders holding large positions report (upon request) and maintain records of such positions and related contracts. It would also increase the fines for violations. The amendment was approved by voice vote.

The Reauthorization Act's clarifications of the CFTC's authority over agreements, contracts and transactions in foreign currency were introduced as a result of the decision in *CFTC v Zelener*.¹⁴ The Zelener case involved off-exchange foreign currency contracts, but it has implications that could reach beyond forex contracts to any type of commodity contract. The court held that the CFTC lacked jurisdiction to bring an enforcement action against a dealer or its agents, because the contracts offered to the general public were spot contracts, and the CFTC's jurisdiction is limited to futures and options contracts. This created a significant gap in the CFTC's ability to prosecute fraud, notwithstanding that Congress had attempted to address any uncertainty in the CFMA. Given the rather large number of recent fraud proceedings involving parties in the retail forex market, this gap is of concern to the CFTC.

In his opening remarks, Chairman Goodlatte said the following of the Reauthorization Act: 'The underlying legislative proposal before the Committee today deals with a recurring problem of unscrupulous persons who prey upon the unsuspecting by offering tantalising ways to make a killing in foreign currency transactions. These persons continue to find

new ways to develop and market their products to skirt the Commodity Exchange Act.’

Expanding the scope of the CFTC’s authority to pursue principals in the event of fraud under Section 4b of the CEA is an important matter to address. In *Commodity Trend Service, Inc. v CFTC*,¹⁵ the Seventh Circuit Court of Appeal ruled that the CFTC could use the antifraud provisions of Section 4b of the CEA solely in ‘intermediated’ trades. Given that the CFMA amended the CEA to allow off-exchange futures and options transactions entered into by principals directly, the amendment to Section 4b(a)(2) of the CEA under the Reauthorization Act would make clear that the CFTC’s antifraud authority also applies to off-exchange non-intermediated trades.¹⁶

Although, in July of last year, the SEC approved a pilot project jointly proposed by the Chicago Board Options Exchange and the New York Stock Exchange, the SEC has generally been slow in moving forward with portfolio margining since the CFMA was enacted. Writing the deadline of September 2006 into the CEA would have the effect of bringing the SEC and the CFTC to the table to make progress on this question. Portfolio margining is an important issue for the futures industry. Market participants are focused on the amount of capital required for investments, and investments in derivatives are no exception. In the US, there are differing approaches to margin requirements. The margin rules that apply to securities regulated by the SEC are not the same as the rules applicable to futures contracts.

Portfolio margining has the advantage of including both futures and securities in the determination of margin, and its methodology sets limits for borrowing by ‘stress testing’ market movements on the entire portfolio, as opposed to considering trades in isolation.

There is opposition to the Reauthorization Act as currently proposed. Concerns have been raised by the International Swaps and Derivatives Association and the Bond Market Association and other associations about the expansion of CFTC jurisdiction beyond futures and options, and they caution against using recent market events as a justification for such expansion.

Finally, it is also interesting to note that CFTC Commissioner Dr Sharon Brown-Hruska, in her keynote speech at a conference of the Association of the Bar of the City of New York on 9th December, 2005, questioned the surveillance and oversight obligations required by the amendment offered by Chairman Goodlatte to the Reauthorization Act. She suggested that it would expand surveillance authority, in a way that is problematic, into areas and markets that are exempt from the CFTC’s jurisdiction, and she questioned the appropriateness and feasibility of imposing exchange-type transparency or enhanced record keeping and disclosure obligations in the private market.

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References

- 1 Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30694 (21st July, 1989), reprinted in [1987–1990 Transfer Binder] Comm. Fut. L.

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- Rep. (CCH) ¶ 24,494 (CFTC 21st July, 1989).
- 2 Khorram Properties, LLC *v* McDonald Investments, Inc. (13th October, 2005).
- 3 McDonald Investments, LLC ('McDonald'), the Respondent, is an introducing broker affiliated with Key Bank National Association.
- 4 7 USC. §§ 1–27f.
- 5 Pub. L. No. 106–554, Appendix E, 114 Stat. 2763 (2000).
- 6 Pub. L. No. 102–546
- 7 Policy Statement, ¶ 24,494 at 36,145–147.
- 8 See ref. 2 above at p. 3.
- 9 See ref. 2 above at p. 4. See also Part 35 Rule Approval, ¶ 25, 539 at 39,588–89 n. 11; see also Over-the Counter Derivatives, 63 Fed. Reg. 26114, reprinted in [1996–1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27, 282 (CFTC May 12, 1998) (the 'Concept Release').
- 10 See ref. 2 above at p.4.
- 11 See ref. 2 above at p. 5.
- 12 See ref. 2 above at p.7
- 13 H.R. 4473
- 14 CFTC *v* Zelener, 373 F. 3rd 861 (7th Cir.), rehearing denied en banc, 387 F. 3rd 624 (7th Cir. 2004).
- 15 15 Commodity Trend Service, Inc. *v* CFTC, 233 F. 3d. 981, 991–992 (7th Cir. 2000).
- 16 The expanded coverage is introduced by adding the words 'or with' to section 4b(a)(2) of the CEA.