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COMMENT

INTEREST RATE SWAPS UNDER THE COMMODITY EXCHANGE ACT

INTRODUCTION

Swap transactions involve an exchange of cash flows between counterparties, "which vary in terms of the currency, interest rate basis and a number of other financial features."1 Essentially, a swap contract is a portfolio of forward contracts.2 The vast majority of swap transactions involve bundled cash-settled forward agreements in which interest rates determine cash flows. Interest rate swaps provide financial risk managers a powerful tool to either mitigate or intensify the exposure of a portfolio to interest rate risk. This Comment analyzes the legal standing of interest rate swaps vis-à-vis the Commodity Exchange Act ("Act").3

The exchange-trading requirement of the Act generally limits the execution of contracts for future delivery of specified commodities to markets approved by the Commodity Futures Trading Commission ("Commission").4 Moreover, the Act prohibits deceptive dealing in such transactions.5 Before 1974, the Act's jurisdiction was limited to contracts for the future delivery of certain finite commodities.6 Under

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1 SATYAJIT DAS, SWAP & DERIVATIVE FINANCING: THE GLOBAL REFERENCE TO PRODUCTS, PRICING, APPLICATIONS AND MARKETS 12 (1994); see also Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694, 30,695 (1989) ("[A] swap may be characterized as an agreement between two parties to exchange a series of cash flows measured by different interest rates, exchange rates, or prices with payments calculated by reference to a principal base (notional amount).") Procter & Gamble v. Bankers Trust Co., 925 F. Supp. 1270, 1275 (S.D. Ohio 1996) ("A swap is an agreement between two parties ('counterparties') to exchange cash flows over a period of time.").


4 See id. § 6(a). Congress established the Commission as an independent federal agency charged with the administration and enforcement of the Act. See id. § 4(a).

5 See id. §§ 6b, 6o.

6 Congress limited the scope of the Grain Futures Act of 1922, the predecessor to the Act, to "wheat, corn, oats, barley, rye, flax and sorghum." Ch. 369, § 2, 42 Stat. 998. The Commodity Exchange Act of 1936 expanded the term commodity to include "wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs and Irish potatoes." Ch. 545, §§ 2, 3(a)-(b), 49 Stat. 1491. From 1936 to 1955, the term evolved to include:
the pre-1974 formulation of the federal commodities law, contracts on interest rates would not have been exposed to the Commission's jurisdiction. However, Congress, through the Commodity Futures Trading Commission Act of 1974 ("1974 Act"), broadened the statutory definition of commodity to include virtually all finite goods and articles and any non-finite service, right, or interest that might potentially form the subject matter of a contract for future delivery.\(^7\)

The consequences of violating the Act make the operation of over-the-counter ("OTC") markets in violative transactions practically impossible. OTC transactions subject to the exchange-trading requirement are illegal and, thus, unenforceable in contract.\(^8\) Moreover, the Act empowers the Commission to petition federal courts to enjoin any person from executing transactions that violate the exchange-trading requirement, to enforce compliance with the exchange-trading requirement, and to take any remedial action necessary "to remove the danger of violation" of the exchange-trading requirement.\(^9\) Upon request of the Commission, a federal court may order participants in illegal OTC transactions to disgorge cash flows obtained through the transaction.\(^10\) Finally, the Act exposes participants in illegal transactions to criminal sanctions,\(^11\) civil penalties,\(^12\) and actual damages in private actions.\(^13\)


7 See 7 U.S.C. § 1a(3) ("The term 'commodity' means ... goods and articles, except onions ... and all services, rights, and, interests in which contracts for future delivery are presently or in the future dealt in.").

8 See id. § 6(a). The general rule is courts would leave parties to an illegal contract where it finds them. There are two exceptions. First, courts typically order restitution when a party is unjustly enriched by receiving a benefit from a less blameworthy party and the less blameworthy party is not guilty of "serious moral turpitude." JOHN D. CALAMARI & JOSEPH M. PERILLO, THE LAW OF CONTRACTS § 22.7 (4th ed. 1998). Second, a party not guilty of "serious moral turpitude" may obtain restitution before "any part of the illegal performance is consummated" when doing so would "prevent the attainment of the illegal purpose for which the bar- gain was made." Id. § 22.8. Most OTC derivative transactions would not qualify for either exception. Since swap participants are generally sophisticated, a court would not likely find one party substantially less blameworthy than the other. Moreover, performance of an OTC derivative arrangement subject to the Act would consummate an illegal performance. Therefore, neither exception to the general rule would apply.


10 See, e.g., CFTC v. Co Petro Mktg. Group, Inc., 680 F.2d 573, 583 (9th Cir. 1982) (affirming a district court order of disgorgement pursuant to finding of an illegal off-exchange transaction).

11 See § 13(c) (providing that illegal off-exchange transactions constitute misdemeanors punishable by a fine of up to $100,000 and/or imprisonment up to one year).

12 See id. § 13a-1(d)(1) (exposing violators to civil penalties of not more than $100,000 or triple the money for each violation). See also Global Link Miami Corp., (1998-1999 Transfer
The Act has been the source of much consternation among OTC interest rate swap market participants. In 1987, the Commission announced that the Act's jurisdiction extended to interest rate swaps. The Commission's assertion implied that OTC interest rate swap transactions violated the exchange-trading requirement. While the Commission took no regulatory action, market participants feared that the implicit assertion meant that OTC swap contracts were illegal and thus, unenforceable. The Commission, responding to harsh criticism, disavowed its assertion in 1989.

Yet the consternation persisted. The Commission attempted to mitigate the legal risk that motivated fears by crafting a safe harbor for swap transactions consistent with the structure of the Act, but to no avail. The safe harbor was incongruent with case law and previous Commission opinions. Moreover, the Commission lacked explicit authority to grant safe harbor. Congress amended the Act through enactment of the Futures Trading Practices Act of 1992 to give the Commission explicit exemptive authority in certain conditions. Pursuant to this authority, the Commission in 1993 adopted the Part 35 safe harbor exemption for swap transactions.

While the swap market grew precipitously after codification of the safe harbor policy, fears attributable to potential exposure under the Act persisted. Three factors explained these fears. First, questions arose as to whether Part 35 exempted swap transactions memorialized in standardized documentation. Second, Part 35 did not exempt interest rate swaps from the anti-fraud provisions of the Act, thus leaving in place a predicate for aggressive Commission policing of the OTC swap market. Finally, the Commission's ill-fated 1998 concept release suggested an aggressive assertion of authority over the OTC derivative markets.

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2. See Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694, 30,694 (1989) ("This statement reflects the Commission's view that at this time most swap transactions ... are not appropriately regulated as [futures contracts] under the Act and regulations.").
3. See id.
5. See Over-the-Counter Derivatives, 63 Fed. Reg. 26,114, 26,115 (1998) (to be codified at 17 C.F.R. pts. 34 and 35) ("The Commission has been engaged in a comprehensive regulatory reform effort designed to update the agency's oversight of both exchange and off-exchange
In December 2000, Congress enacted the Commodity Futures Modernization Act of 2000 ("Modernization Act"), which provides a statutory exemption for most OTC derivative transactions from the exchange-trading requirement and the anti-deception provisions of the Act. The sweeping nature of the exemption should allay much of the fear among interest rate swap participants attributable to the federal commodities law. However, the Modernization Act does not provide an absolute shield from legal risk. Only transactions involving parties meeting a statutorily defined suitability requirement are exempted. Moreover, Congress explicitly left OTC derivative transactions exposed to state causes of action.

The Commission's sporadic, ad hoc interventions (proposed and actual) into OTC derivative markets drove the practical concerns that motivated the enactment of the Modernization Act. This Comment looks into whether such congressional action was necessary for reasons beyond practicality. That is, the Comment analyzes whether the Act's jurisdiction before enactment of the Modernization Act extended to OTC interest rate swaps. Such analysis could be of real concern for potential interest rate swap participants who do not fall under the Modernization Act's exemptions. Moreover, the Comment discusses the scope of the Modernization Act as it applies to interest rate swaps.

The analysis of whether interest rate swaps generally fell within the Act's jurisdiction prior to enactment of the Modernization Act, or whether interest rate swaps not qualifying for statutory exemption fall within the Act's jurisdiction, focuses on the interpretation of "contract . . . for future delivery"—the main jurisdictional boundary of the Act—as modified by the deferred-delivery exception. Case law and the Commission's administrative opinions contain two methods for interpreting the term.

The first method, pervasive in cases involving finite, tangible commodities, endeavors to hold all contracts executed for speculative reasons within the Act's jurisdiction. There are two approaches to this method. The first uses anticipated delivery as a proxy for whether the counter-parties executed the deal for non-speculative purposes. While this approach promotes analytical efficiency by relieving courts of the need to inquire into complex risk-management issues, the approach is over-inclusive in that it brings within the

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21 See id. § 101.
22 See id. § 117.
Act's jurisdiction, before enactment of the Modernization Act, all risk-shifting transactions, including hedging and arbitrage activity. An alternative to the delivery proxy approach, advanced by Judge Sotomayer, requires courts to determine directly whether the counterparties acted pursuant to speculative purposes.

The second method, advocated by Judge Easterbrook, rejects the anti-speculation bias at the heart of the first method. That method, wrote Judge Easterbrook, assumes "future" has a "lay rather than a technical meaning." Alternatively, he argues that "the language has a technical reference—that the statute specifies the kind of contracts that trade in futures markets." Under this method, only transactions having institutional characteristics substantially similar to exchange-traded futures fall under the contract for future delivery term.

The question analyzed in this Comment is still relevant to potential swap market participants who would be suitable market participants under market standards but not under the statutory suitability requirement, as modified by the Commission. However, the Modernization Act suggests certain presumptions that make it unlikely that courts will find interest rate swap deals not meeting the exemptive requirements to be beyond the Act's jurisdiction, even though a good argument for such a result, based on Judge Easterbrook's observation, can be made.

I. THE INSTITUTIONAL CHARACTERISTICS OF FORWARD AND FUTURES TRANSACTIONS AND AN INSTITUTIONAL COMPARISON OF OTC INTEREST RATE SWAPS AND FUTURES TRANSACTIONS

A. The Forward Transaction: The Basic Building Block of a Swap

1. Definition and Illustration

The basic building block of a swap is the forward transaction. Through a forward transaction, the buyer "agrees to pay a specified amount at a specified date in the future" in exchange for "a specified amount of [currency, commodity, or coupon payment] from the counterparty." At expiration, forward contracts either require actual delivery of the underlying commodity or provide for cash settlement.

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24 See MG Ref. & Mktg. v. Knight Enter., Inc., 25 F. Supp. 2d 175, 188 (S.D.N.Y. 1998) (considering whether the parties were "willing to seize on the opportunity to speculate").
26 Id. (emphasis added).
28 SMITHSON, supra note 2, at 54.
To illustrate, suppose that Dillonator, a United States-based manufacturer, wishes to purchase from Scott Industries, Dillonator’s foreign supplier, a supply of widgets in six months time. Scott quotes Dillonator a six months forward price in British pounds that, at the current exchange rate, would give Dillonator a reasonable possibility of turning an economic profit for the next production cycle.

At this point, Dillonator faces two kinds of financial risk: price risk and exchange rate risk. To mitigate price risk, Dillonator enters into a forward agreement with Scott for the delivery of widgets in six months time in exchange for the six-month delivery of the agreed upon forward price in British pounds. The forward contract effectively hedges Dillonator’s natural short position (where operations require inputs that are not owned) in widgets with a long position (contractually promising to purchase specific goods in the future). However, this forward deal does not mitigate Dillonator’s exposure to currency risk. To insulate itself from such risk, Dillonator enters into a foreign-exchange forward contract with Warrick Bank. Through that deal, Warrick Bank agrees to exchange with Dillonator an appropriate amount of pounds sterling for U.S. dollars with reference to the six-month forward exchange rate.

The potential subject matter of forward contracts is not limited to physical commodities. Theoretically, a forward contract can be based on any process that can be modeled as a random variable. Consider forward contracts on interest rates. Most entities, financial or otherwise, face exposure to interest rate volatility. Cash-settled forwards on interest rates, known as forward rate agreements, help manage the effects of such exposure. Such an agreement involves a contractually prescribed cash flow at some future date determined with reference to the difference between the relevant forward interest rate, known at formation, and the relevant future spot rate, known at maturity. To illustrate, suppose that Dillonator must borrow $3 million in six months for a term of three months and is concerned that the three-month rate might rise in the next six months. To alleviate its concern, Dillonator enters into a 6x9 forward rate agreement with a $3 million notional. Thus, Dillonator locks in its interest rate costs for the borrowed money.

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29 See HULL, supra note 2, at 95-97. Net cash payment of a forward rate agreement (“FRA”) at $t_0$ (settlement date) or $t_1$. Let $\text{FRA}_{t_0,t_1}$ represent the annualized fixed rate determined at date 0 for the period $[t_0,t_1]$. Let $\Delta t = t_1 - t_0$ be the time period in years. Let $l[t_0,t_1]$ represent the reference rate, usually the relevant LIBOR (the London inter-bank offering rate), also in annualized form, that prevails at the settlement date, $t_0$. The net cash payment to the buyer of an FRA at $t_1$ is, $Q(t_0)$, given by $Q(t_0) = N[l[t_0,t_1] - \text{FRA}_{t_0,t_1}]\Delta t$, where $N$ notional principle. Most FRAs call for payment at settlement date $t_0$. Under such conditions, the net payment to buyer would be $C(t_0)$, given by $C(t_0) = Q(t_0)[1 + l[t_0,t_1]]\Delta t$. That is, the payment at $t_0$ is the present value at $t_0$ of the payment that would otherwise be received at $t_1$.

30 Dillonator’s interest exposure from the forward loan is $3,000,000(1 + (l[6,9](1/4)))$ payable in nine months. The three-month spot rate in 6-months, $l[6,9]$, is unknown. Hence, the
INTEREST RATE SWAPS

Interest rate swaps—a vanilla interest rate swap is nothing more than a portfolio of forward rate agreements.

While the forward transaction is an important risk-management tool, such transactions are not appropriate for everyone. Beyond financial risks, forward deals expose participants to considerable credit risk. Credit risk, or performance risk, is the risk that a counterparty will not perform as promised. Credit risk is such a fundamental aspect of forward deals that most forward contract provisions deal with credit issues, especially default. The credit intensive nature of forward transaction deals makes them more appropriate for large corporations, large institutions, and governments than for smaller players.

2. Distinguishing Forward Transactions from Futures Transactions

Judge Easterbrook argues that the main jurisdictional element of the Act extends only to futures transactions, as distinguished from forward transactions. Like forwards, futures obligate "one counterparty to buy, and the other to sell, a specific underlying [asset, rate, index, or commodity] at a specific price, amount, and date in the future." However, there are significant institutional differences between forwards and futures. First, futures are rigidly standardized—that is, exchanges typically standardize all terms of futures contracts except for price. They determine the underlying asset, quantity to be delivered, daily limits on price movements, contract months, delivery dates, quality terms, delivery location, and tick size (minimum allowable price change). Futures transactions involve no bilateral negotiation other than for the price term. On the other hand, forward transactions are bilaterally negotiated.

Second, futures positions, generally, "mark-to-market" daily. The marking-to-market process mitigates credit risk, thus making futures transactions less credit intensive than forward transactions.

Loan presents Dillonator with interest rate risk. To mitigate the risk, Dillonator buys a 6x9 FRA. In six months, the pay out to Dillonator under the FRA is $3,000,000([6,9] - FRA[6,9](1/4)) / (1 + (1/4)). The value of the FRA cash flow in nine months is $3,000,000([6,9] - FRA[6,9](1/4)) / (1/4). Thus, Dillonator's net exposure in nine months will be $3,000,000([6,9] - FRA[6,9](1/4)) - $3,000,000(1 + ([6,9](1/4))) = -$3,000,000(1 + FRA[6,9]). Accordingly, the purchase of a FRA transformed Dillonator's variable-interest rate exposure into a fixed-rate exposure.

See Smithson, supra note 2, at 60.
See id.
McLaughlin, supra note 27, at 66 (alteration in original).
See id. at 72 ("[T]he quantity and quality of the underlying [commodity] is specified by the exchange, as are the time, place, and method of payment or settlement.").
See Hull, supra note 2, at 20-23.
See McLaughlin, supra note 27, at 72.
See id.
Essentially, this process involves a daily settling and rewriting of the futures position. Upon undertaking futures positions, traders post initial margins. When the exchanges settle and re-write futures positions at the daily closing futures price, they adjust the traders’ margin accounts to reflect the daily change in the futures price. For instance, suppose that Willie and Foley establish short and long positions, respectively, in a particular wheat future at a futures price of $100. Upon executing the futures deals, the exchange requires Willie and Foley to post margins of $10. The next day, the futures price closes at $103. When the exchange marks the positions to market, it closes out both and re-establishes them at the new futures price. Upon closing out the positions, the exchange adds three dollars to Willie’s account and deducts three dollars from Foley’s account. If the trader’s margin account falls below the maintenance margin, the exchange requires the offending account to be replenished to the initial margin. If the trader refuses, the exchange liquidates the trader’s position. At maturity, if the trader has not previously closed his position through an offsetting transaction, the trader takes (or makes) delivery of the underlying commodity at the spot price.\(^3\)

Returns under futures deals are path-dependent—total profit on a futures position depends on the sequence of price movements over the holding period.\(^4\) For instance, suppose that the futures price upon entering a long futures position is $100 and the spot price at maturity is $110. If the futures price gradually increases to $120 and then decreases to $110, the holder of a long futures position is better off than if the futures price gradually decreases to $90 and then steadily increases to $110. This is because the early increase generates profits that earn interest over a relatively longer period, while the latter decrease requires financing over a shorter period. Contrast this with a forward transaction, where the forward price path does not affect returns. Returns under forward arrangements depend only on the difference between the forward price at contract formation and the spot price at maturity.

Finally, futures market participants do not execute transactions between themselves. Rather, all futures market participants deal with the clearinghouse. The purpose of the clearinghouse is to further re-

\(^3\) At maturity, the forward price of a commodity must converge to its spot price. Otherwise, a risk free arbitrage opportunity would exist. Let \(F_t\) be the forward price at maturity and \(S_t\) be the spot price at maturity. Suppose that the forward price at maturity were greater than the spot price. Then a trader could theoretically sell the commodity forward at \(F_t\), immediately purchase the commodity on the spot market at \(S_t\), and cover his obligation under the forward. Under this strategy, the trader would receive \(F_t\) and pay \(S_t\). Since \(F_t > S_t\) and the strategy involves no risk, such a circumstance would yield a pure arbitrage profit. Minor discrepancies might exist, however, due to market imperfections such as transaction costs.

\(^4\) See BRUCE TUCKMAN, FIXED INCOME SECURITIES 173 (1995) (“The final value of the position . . . depends on the evolution of interest rates over the life of the contract.”).
duce credit risk. Instead of facing counterparty credit risk, futures traders face the credit risk presented by the clearinghouse, which is considerably less. Fundamentally, the clearinghouse pools credit risks inherent in the futures market operations, spreading the costs of such risk among market participants, and manages credit risks presented by individual traders. Moreover, the clearinghouse facilitates closing transactions. The holder of a futures position need not find a counterparty and negotiate an offsetting transaction to close his position before maturity because the clearinghouse guarantees a willing and able party to offsetting transactions. Contrast this with forward transactions, where participants must bear counterparty credit risk and can only offset their positions through separately negotiated transactions.

B. Interest Rate Swap Transactions

1. Structure and Use

A vanilla interest rate swap, the simplest form, involves “[a]n exchange of a fixed rate of interest on a certain notional principle for a floating rate of interest on the same notional principal” at periodic intervals over a predetermined quantum of time. Generally, interest rate swap participants use such transactions to transform floating-rate liabilities or assets into fixed-rate liabilities or assets, or visa versa. Though these swaps give risk managers a powerful tool to either mitigate or intensify an organization’s exposure to interest rate risk, intermediaries have developed increasingly complex interest rate swap structures to meet the unique needs of market participants. The complexity of such instruments is limited only by market demand and the ability to price.

To illustrate the utility of interest rate swaps in mitigating interest rate risk, consider the following hypothetical involving the use of plain vanilla interest rate swaps. Takeo Community Bank, a small community-based lending institution, holds a portfolio of long-term (fifteen- and thirty-year) fixed-rate mortgages and funds its lending

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41 See MCLAUGHLIN, supra note 27, at 72.
42 While considerably less, some credit risk persists. See, e.g., Moody's Sees Dangers in Futures Clearinghouse, THOMPSON'S INT'L BANKING REG., July 10, 1995, at 4 (reporting concern that some clearinghouses might not be able to survive the collapse of large institutional futures market participants); cf. Carol Jouzaitis & Lourie Cohen, $8 Million Loss for Options Guarantor, CHI. TRIB., Dec. 5, 1987, at C4 (reporting that the failure of a large options market participant forced a U.S. stock options clearinghouse to avert disaster by "dip[ping] into a fund that was created to cover the obligations of failed firms").
44 HULL, supra note 2, at 665.
45 See id. at 124-25 (illustrating the mechanics of such financial transformations).
operations with deposits. To attract depositors, Takeo must adjust its deposit rates every three months. The maturity mismatch between Takeo’s loan portfolio and deposit obligations leaves it dangerously exposed to interest rate volatility. For illustration, suppose Takeo’s mortgage portfolio returns a fixed seven-percent annual. As long as short-term interest rates remain below seven percent, Takeo’s interest rate cash flow would be positive. However, when short-term interest rates rise above seven percent, Takeo loses money. The financial risk threatens Takeo’s solvency. Interest rate swaps provide Takeo a powerful tool to manage the problem.

Recognizing the peril presented by its exposure to interest rate risk, Takeo agrees to a par rate swap arrangement with Simmons Bank so that no up-front cash flow is required. The terms of the deal require Takeo to pay Simmons a fixed rate on a notional every quarter in exchange for a variable rate on the notional. The notional principle is not exchanged, but only serves as a reference for determining cash flows and is set at an amount appropriate for Takeo’s hedging needs. As Figure 1 shows, the interest rate swap effectively mitigates Takeo’s interest rate exposure in that the variable-rate exposure to depositors is offset by the variable-rate receipts from Simmons.

**Figure 1**

Takeo’s Interest Rate Exposure After the Swap Deal

| Customers | 7.00% (annual) | | Takeo Bank | 6.80% (annual) | | Simmons Bank |
|-----------|----------------|----------------|
| ![Diagram](Image) |

Market participants also use interest rate swaps to intensify exposure to interest rates, especially when organizations believe their institutional capabilities render their views on interest rates more intelligent than mere speculative opinion. While corporate boards who pay attention to such things tend to be suspicious of such activity, the allure of reducing all-in funding costs of debt sometimes overcomes suspicion.

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46 Since no principle is exchanged, par interest swaps entail very little credit risk. See TUCKMAN, supra note 40, at 191 ("[T]he nature of swap cash flows and the provisions of swap agreements greatly reduce the importance of credit risk."). According to studies conducted by the International Swap and Derivatives Association, Inc., actual economic risk presented in an interest rate swap transaction "amounts to a small fraction of the notional principal, typically from around 2% on gross to 1% on net." International Swaps and Derivatives Ass’n, Inc., ISDA 1997 Year-End Market Survey (visited Mar. 3, 2001) <http://www.isda.org/statistics/recent.html#1997>. Nevertheless, credit risk is an issue. In practice, only institutions with investment-grade debt participate in the OTC swap markets. Moreover, marginal players are sometimes required to support their swap obligations with collateral.
Consider the case of the infamous 5/30-interest rate swap between Procter & Gamble ("P&G") and Bankers Trust ("BT") as illustrated in Figure 2. In November 1993, P&G and BT entered a five-year, semiannual swap with a notional principle value of $200 million. BT agreed to pay P&G a fixed rate of 5.3%. P&G initially agreed to pay a floating rate based on the thirty-day commercial paper daily average rates, less seventy-five basis points, plus a spread. By accepting the terms offered by BT, P&G essentially gave BT an interest rate option contingent on the five-year and the thirty-year treasury rates in return for a constant rate discount off the floating rate at each settlement date. P&G and BT subsequently amended the contract in January 1994, giving P&G an eighty-seven basis point premium each settlement date.

Figure 2
Schematic of Cash Flows at Each Semiannual Settlement Date

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\begin{figure}
\centering
\begin{tikzpicture}
  \node (bt) {BT};
  \node (pg) [right of=bt] {P&G};
  \draw [->] (bt) -- node [above] {30-day CP Daily Avg. - 75 bp + Spread ("s")} (pg);
  \draw [->] (pg) -- node [below] {5.30\%} (bt);
  \node [above of=bt] {floating rate obligation};
  \node [above of=pg] {Contingent fixed obligation determined at first semiannual settlement date. The "option" pay out formula.}
  \node [left of=bt] {option premium (fixed)};
\end{tikzpicture}
\end{figure}
```

"CP" is the commercial paper rate.

Potentially, the deal could have reduced P&G's all-in interest rate costs on $200 million in debt to below the risk-free rate if interest rates had fallen, remained stable, or increased slightly. Figure 3 illustrates that under such conditions, the embedded option would have expired out of the money and P&G would have paid BT the daily average of the thirty-day commercial paper rate less eighty-seven ba-

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48 Spread = Max [0, s], where s = \((98.5(5yr CMT\% / 5.78\%) - (30 year TSY price)) / 100.

"CMT" represents the yield on a five year constant maturity note. The "TSY" price represents the 30-year Treasury bond (not including accrued interest).

49 See Smith, supra note 47, at 70.

50 I.e., Max[0,s] = 0.
sis points. At the time, the spread between the thirty-day treasury rate and the thirty-day commercial paper rate averaged about twenty-five basis points. Thus, P&G would have enjoyed a below-Treasury cost on the $200 million notional amount as long as the spread between the thirty-day commercial paper rate and the concomitant treasury rate stayed below eighty-seven basis points.

**Figure 3**

**Schematic of Cash Flows at Each Semiannual Settlement Date, Assuming the Embedded Option Expired Out of the Money (i.e., the spread is set at zero).**

Option expires out of the money max[0,s] = 0.

30-day CP Daily Avg. − 87 bp

<table>
<thead>
<tr>
<th>BT</th>
<th>5.30%</th>
</tr>
</thead>
<tbody>
<tr>
<td>P&amp;G</td>
<td></td>
</tr>
</tbody>
</table>

Unfortunately for P&G, interest rates did not move as its treasury managers had anticipated. The swap payoff formula was extremely sensitive to rising interest rates once interest rates rose high enough for the spread to have positive value. Once in the money, a one basis point parallel increase in the five- and thirty-year rates reduced (from P&G's perspective) the value of the embedded option, and thus the swap, an estimated $5.7 million. P&G lost much because, by the time P&G had fully unwound its position in late March 1994, interest rates had risen precipitously. On paper, P&G liability to BT was well over $100 million, but things could have been worse. Had P&G waited until the first settlement date in May 1994 to unwind its position, P&G would have been over $450 million in debt. P&G successfully avoided much of its debt to BT through litigation.\(^{51}\) Nevertheless, P&G fired its treasurer and demoted several managers who had worked with BT to arrange the deal. Moreover, CEO Edwin Artzt reduced his annual bonus by $100,000, reducing his pay to $2.3 million for 1994.

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\(^{51}\) See infra Part III.B.
2. Distinguishing Interest Rate Swaps from Futures Transactions Institutionally

a. Standardization: OTC Swap Market Standardization Is of a Different Nature than Futures Market Standardization

Vanilla swap contracts involve highly standardized documents generally modeled after relevant International Swap and Derivatives Association, Inc. ("ISDA") master agreements. Commentators suspicious of financial speculation have noted the increasing ease with which market participants engage in offsetting transactions—facilitated by such standardization—and rendering such swaps substantially similar to futures transactions for purposes of interpreting the deferred-delivery exception of the Act. However, these commentators disregard a critical difference between OTC swaps and exchange-traded futures.

On one hand, OTC swap market participants freely negotiate variations from the standardized terms contained in ISDA master agreements without the prior approval, or oversight, of regulators. While vanilla swap contracts tend to have common terms, the parties may negotiate changes through bilateral negotiation. This characteristic of the interest rate swap market has facilitated innovations in interest rate swap structure in recent history. On the other hand, futures exchanges do not allow negotiation of terms except for price. Until recently, proposals for new futures contracts had to be pre-approved by the Commission under a public interest test. This regulatory model worked to stymie financial innovation. Recog-

54 See Barry Taylor-Brill, Negotiating and Opining on ISDA Masters, in SWAPS & OTHER DERIVATIVES IN 1999, 81, 95 (Kenneth M. Raisher & Alison M. Gregory eds., 1999) ("The challenge for [lawyers who draft swap agreements] is finding a balance between changing the Master or Schedule to suit one's personal desires and forcing all transactions into a standardized mold.").
56 See After CFTC Setback, Chicago Exchanges Appeal to Congress for Regulatory Relief, SEC. WK., May 24, 1999, at 8 (reporting on futures exchanges' effort to persuade Congress to amend the Act to allow bilaterally negotiated contacts not approved by the Commission to trade on futures exchanges.); Michael Debaie, U.S. Futures Exchanges Seek More Autonomy
nizing this, the Commission revised its regulations to allow futures exchanges to list new contracts “pursuant to exchange certification” without prior approval, and Congress provided numerous exceptions under the Act for the development of futures markets on certain financial commodities. While the regulatory and statutory changes are expected to facilitate innovation, time will tell how the futures exchanges will evolve.

b. Convexity Bias in the Pricing of OTC Interest Rate Swaps Suggests that the Marking-to-Market Characteristic Is a Significant Institutional Difference Between OTC Interest Rate Swaps and Futures Transactions

The presence of a persistent bias in swap rates relative to theoretical rates implicit in futures prices suggests that the marking-to-market feature of the futures arrangement is an economically significant institutional difference between interest rate swaps and futures. Financial economists have long recognized the marking-to-market feature of futures transactions explains the differential between forward and futures prices, denoted as convexity bias. Recently, Gupta

From CFTC, SEC. INDUSTRY NEWS, July 12, 1999, at 1 (reporting that U.S. futures exchanges “said they should be allowed to list new contracts for trading without Commission preapproval” in order to remain competitive with foreign futures exchanges); TMA’s End-Users of Derivatives Council Reinforces Importance of Derivatives: Calls for Modernization of Commodity Exchange Act, Pr Newswire, June 8, 1999, available in WESTLAW, Westnews Library, PR Newswire (Dialog) file (announcing Treasury Management Association’s call on Congress to, among other things, “reduce or eliminate obstacles to the development of new products” in the futures markets). Cf. Jerry W. Markham, “Confederate Bonds,” “General Custer,” and the Regulation of Derivative Financial Instruments, 25 SETON HALL L. REV. 1, 41 (1994) (recognizing a need to regulate OTC derivative markets but maintaining that an exchange-trading requirement for OTC derivatives would "stifle an innovative and economically valuable market").


See Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, § 114, 114 Stat. 2763 (2000). To qualify, exempt exchanges must limit trading to contracts on commodities with “a nearly inexhaustible deliverable supply,” i.e., a supply large enough to make market manipulation unlikely. Id. Moreover, only eligible contract participants (that is, suitable parties) may trade on such exchanges. Finally, contracts on securities or securities related indexes may not be traded on exempt exchanges. Significantly, however, contracts traded on exempt contract markets are subject to the anti-deception provisions of the Act. See id. Such exposure provides a basis for significant regulatory oversight.

See Anurag Gupta & Marti G. Subrahmanyam, An Empirical Examination of the Convexity Bias in the Pricing of Interest Rate Swaps, 55 J. FIN. ECON. 239, 240-41 (2000) (surveying pertinent literature suggesting the existence of statistically significant convexity bias between forward and futures contracts); but cf. Aswath Swath Damodaran, INVESTMENT VALUATION: TOOLS AND TECHNIQUES FOR DETERMINING THE VALUE OF ANY ASSET 459 (1996) (“In most real-world scenarios, and in empirical studies, the difference between futures and forward prices is fairly small and can be ignored.”); Hull, supra note 2, at 61-62 (summarizing empirical research indicating mixed results).
and Subrahmanyam found that the marking-to-market feature explains an analogous differential between market-swap rates and theoretical swap rates derived from Eurodollar futures prices. If highly standardized vanilla swap transactions were economically equivalent to futures transactions, one could infer accurate swap rates from futures prices. The evidence of persistent convexity bias between market swap rates and swap rates inferred from futures data belies claims of substantial similarity between the OTC interest rate swaps and exchange-traded futures.

To understand the underlying economics of convexity bias as applied to interest rate swap valuation, consider the value of a short-swap position. By convention, the party who receives fixed-rate payments and makes variable-rate payments holds the short-swap position. When forward rates fall, the value of the short position increases since the anticipated fixed receipts are more attractive relative to the anticipated variable-rate payments. Conversely, when forward rates rise, the value of the short position decreases because the anticipated fixed receipts are less attractive relative to the anticipated variable rate payment. Nominally, "the value of the gain on a short swap when the forward rate falls is equal to the nominal loss on the position when the forward rate rises." However, since cash flows only occur on payment dates, anticipated gains and losses must be discounted to present value. When interest rates fall, the discount rate falls; when interest rates rise, the discount rate also rises. Therefore, the gain on the short swap from a decrease in forward rates is worth more than the loss from an increase in forward rate of equivalent magnitude—that is, the short swap exhibits positive convexity. In contrast, Eurodollar futures positions settle every day according to marking-to-market requirements. Thus, holders of Eurodollar futures positions realize gains and losses right away, rather than at some future payment date. For this reason, Eurodollar futures do not demonstrate convexity. Therefore, the swap rate deduced from futures rates implied from Eurodollar futures prices swaps is generally substantially different from the market swap rate.

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60 See Gupta & Subrahmanyam, supra note 59, at 248-56. The authors test several alternative explanations for the differential. Their tests show that variation in default risk does not substantially explain the variation in the differential, that information asymmetry has an inconsequential effect on the differential, and that variation in market liquidity did not substantially explain variation in the differential. However, the test results show that each of the factors does have a small but statistically significant effect on the differential in certain circumstances. See id. at 257-64. Gupta and Subrahmanyam admonish readers interested in accurate swap valuation to adjust for convexity bias when using rates derived from futures prices to value interest rate swaps. See id. at 240.
61 This explanation is adapted from Gupta and Subrahmanyam. See id. at 244.
62 Id.
63 See id.
3. The Clearinghouse

As discussed above, futures market participants do not contract with one another but with the exchange clearinghouse. The clearinghouse, by guaranteeing counterparty performance, mitigates counterparty default risk and facilitates closing trades for those holding futures positions and wanting to unwind their positions before maturity. Analogous to exchange clearinghouses, market makers in the swap market, generally large commercial banks, reduce the credit risk of market participants by facilitating offsetting transactions. Unlike clearinghouses, however, market makers do not always, and are not obligated to, stand ready and willing to consummate offsetting transactions with market participants. Thus, market participants desiring to unwind swap positions must negotiate offsetting transactions with a market maker, another counterparty, or in the secondary market.

Some inroads to the development of a swap clearinghouse have been made, but the prospect is not promising in the near term. The first swap clearinghouse, SwapClear, commenced operations in late 1999. SwapClear offered holders of a limited range of swap positions clearing services analogous to those available on futures exchanges. However, SwapClear failed to clear significant volumes, probably because of SwapClear’s risk management protocols. Recently, a consortium of banks announced the development of a new electronic settlement process that its creators hope will capture sixty percent of the OTC swap market. Very few market participants currently execute transactions through such clearing systems.

II. JURISDICTIONAL AMBIGUITY OF THE ACT PRIOR TO ENACTMENT OF THE MODERNIZATION ACT

A. Analysis of the Contract for Future Delivery Boundary

The exchange-trading requirement of the Act generally prohibits execution of contracts for the future delivery of statutory commodities beyond the rules of exchanges designated by the Commission. Moreover, the Act prohibits deceptive dealing in such transactions.

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64 See Richard Irving, LCH Shunned as Banks Back SwapClear Rival, FIN. NEWS, June 5, 2000, available in LEXIS, Financial News Group File (“Market sources believe that less than a dozen swaps players have signed up [with SwapClear] and that with the exception of possibly one U.S. firm, none of the top firms have joined.”).
65 See id. (“[T]he limited range of swaps covered by the service as well as a clause stipulating that members must unwind all their positions if in the scheme they are the subject of an unexpected downgrade by rating agencies.”)
66 See id.
68 See id. §§ 6(b), 6(o) (prohibiting fraud and providing for the establishment of enforcement mechanisms).
The Act gives the Commission exclusive jurisdiction over transactions falling within the ambit of the Act’s jurisdiction. Before 1974, the Act’s jurisdiction was limited to contracts for the future delivery of certain finite commodities. Congress greatly expanded the scope of the Act’s jurisdiction through enactment of the 1974 Act, which broadened the statutory definition of commodity beyond finite goods and articles to include any non-finite service, right, or interest that might potentially form the subject matter of a contract for future delivery. Under this formulation, the statutory definition of commodity, stretched beyond its intuitive meaning, affords no limit to the Act’s jurisdiction. Accordingly, one had to look elsewhere for effective bounds. Prior to the enactment of the Modernization Act, the Act had three statutory jurisdictional boundaries. The critical issue when analyzing dollar denominated interest rate swaps involved the scope of the term “contract for future delivery.”

1. The Traditional Model: Anticipated Delivery as Proxy for Inquiry into Speculative Intent

a. The Traditional Model: Introduction

The Act’s jurisdiction extends, if no exemption applies, to transactions involving future delivery of statutory commodities, except...
those for deferred delivery.\textsuperscript{75} Traditionally, the Commission and courts have proceeded under the assumption that Congress intended the Act to control speculative forward trading in commodities. Accordingly, the deferred-delivery exception is read narrowly. While purporting to engage in a fact-intensive, multi-factor analysis,\textsuperscript{76} courts often reduce the analysis to a subjective inquiry—whether contracting parties contemplated actual delivery of the underlying commodity.\textsuperscript{77}

Under this model, the Commission and the courts tolerate over-inclusiveness for analytical efficiency. By serving as a proxy for non-speculative dealing, contemplated delivery obviates the need for more complex inquiries necessarily involving financial engineering matters. Adjudicators simply deem executory transactions that do not contemplate delivery to be speculative and, thus, not qualified for the deferred-delivery exception. If the goal is to police speculative activity, the traditional model is over-inclusive since it requires adjudicating bodies to subject all risk-shifting transactions to the Act's jurisdiction, whether affected for hedging, speculative, or arbitrage purposes.

One court has demonstrated distaste for the traditional model's tradeoff, while remaining true to the theory that the Act reflects Congress's purported distrust of speculative dealing. As discussed below, Judge Sotomayer rejected the traditional model in favor of an approach requiring explicit consideration as to whether the transaction in question advanced speculative ends.\textsuperscript{78}

\textit{b. Development of the Traditional Model}

The Commission fashioned the traditional model in 1978. At first, the Commission appeared to have adopted a model much more

\textsuperscript{75} See id. § 1(a)(11). The deferred-delivery exception is also known as the cash commodity exception or the cash forward exception.

\textsuperscript{76} See, e.g., Grain Land Coop v. Kar Kim Farms, Inc., 199 F.3d 983 (8th Cir. 1999). In Grain Land, the court engaged in an individualized, multi-factor approach [that] scrutinize[d] each transaction for such characteristics as whether the parties are in the business of obtaining or producing the subject commodity; whether they are capable of delivering or receiving the commodity in the quantities provided for in the contract; whether there is a definite date of delivery; whether the agreement explicitly requires actual delivery, as opposed to allowing the delivery obligation to be rolled indefinitely; whether payment takes place only upon delivery; and whether the contract's terms are individualized, rather than standardized. See id. at 991.

\textsuperscript{77} See id. ("In order to determine whether a transaction is an unregulated cash-forward contract, \textit{we must decide whether there is a legitimate expectation that physical delivery of the actual commodity by the seller to the original contracting buyer will occur in the future.}") (emphasis added) (internal quotation marks and citations omitted); CFTC v. Trinity Metals Exch., Inc., No. 85-1482-CVW3, 1986 U.S. Dist. LEXIS 30238, at *8 (W.D. Mo. Jan. 21, 1986) (positing that the original purpose of the deferred-delivery exception was "to ensure that the [Act] did not interfere [with transactions] where delivery of the actual grain was expected").

circumscribed than the traditional model in holding that the deferred-delivery exception applied to all forward transactions except those effected by "a group of persons whose activities bring them within the definition of a board of trade."\footnote{CFTC Interpretive Letter No. 77-12 (Dealers in GNMA Certificates Board of Trade), [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,467 (Aug. 17, 1977).} Though the precise jurisdictional scope of the Act under such a board of trade model is indeterminate because the statutory definition of board of trade is ambiguous,\footnote{Alton Harris has proposed that a board-of-trade model be adopted. To clarify the board-of-trade ambiguity, he proposed that the Act’s jurisdiction be limited to contracts executed on a contract market—contracts marketed and sold to the general public. \textit{See} Alton B. Harris, \textit{The CFTC and Derivative Products: Purposeful Ambiguity and Jurisdictional Reach}, 71 CHI. KENT. L. REV. 1117, 1178 (1996).} it would likely result in a more narrow jurisdictional scope than the traditional model. Nevertheless, the Commission adopted the more expansive model within a year. In an interpretive letter released in 1978, the Commission pronounced that the Act’s jurisdiction generally extends to all transactions for the future delivery of statutory commodities except those

solely for the benefit of persons involved in a commercial cash commodity business, which would allow them to effect cash sales of the commodity, contemplating actual delivery as a matter of course, but in which shipment or delivery of the commodity might be deferred for purposes of commercial convenience or necessity.\footnote{Memorandum to the CFTC from Office of General Council, 44 Fed. Reg. 13,498, 13,498 (1979).}

The Commission accentuated the approach soon after. In \textit{In re Stovall}, the Commission first applied the traditional model to a controversy. Through the transactional form in question, participants did not expect delivery of the underlying commodity—the relevant contract was standardized and almost always settled for cash.\footnote{\textit{See In re Stovall}, [Transfer Binder 1977-1980] Comm. Fut. L. Rep. (CCH) ¶ 20,941 (C.F.T.C. Dec. 6, 1979).} In determining whether the Stovall contract qualified for the deferred-delivery exception, the Commission reasoned that Congress meant to limit its application to those for whom the “desire to acquire or dispose of a physical commodity is the underlying motivation for entering [the] contract, [but in which] delivery [is] deferred for purposes of convenience or necessity.”\footnote{\textit{Id.} ¶ 23,778.} Thus, while observing that Stovall’s firm “consistently used and promoted [the contract] as a means of speculating on changes in the price of cash commodities which might occur in the future,”\footnote{\textit{Id.}} the Commission held against Stovall solely on the basis of the lack of intended actual delivery of the underlying
commodity. Until 1990, the Commission consistently and unambiguously reiterated this idea, stressing the expectation of delivery as the analytical lodestar for determining whether a particular transaction qualifies for the deferred-delivery exception.

Courts readily adopted the traditional model. The Ninth Circuit upheld the Commission’s approach in its first consideration of the question. In Commodity Futures Trading Commission v. Co Petro Marketing Group, Inc., Co Petro marketed contracts for the prospective delivery of petroleum products. Under the agreement, the customer appointed Co Petro as its agent to purchase a specified quantity and type of product at a future date. The customer paid a fixed percentage of the forward price as a deposit and was not required to take delivery, having the option of appointing Co Petro his agent to sell the fuel on his behalf. If the price went up, Co Petro remitted the difference in price between the forward price and the market price to the customer, along with the return of his deposit. If the price of fuel fell, Co Petro deducted from the deposit the difference between the forward price and the market price, and sent the balance back to the customer. A liquidated damages clause limited customer losses to ninety-five percent of the initial deposit.

In determining whether these contracts qualified for the deferred-delivery exception, the Ninth Circuit rejected a bright line test because the appropriate analysis required the court to cast “a critical eye toward [the transaction’s] underlying purpose.” Like the Commission, the critical eye of the Ninth Circuit focused a myopic gaze on the question of anticipated delivery. While holding that the Co Petro contract did not qualify for the deferred-delivery exception—because Co Petro sold the contracts “merely for speculative purposes”—the court based its finding of speculative intent on its conclusion that neither Co Petro nor its customers predicated their dealing on an ex-

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85 See id. ("Few, if any, of the transactions entered into were motivated by a desire to acquire or dispose of actual commodities.") (footnote omitted).
86 See, e.g., Habas v. American Bd. of Trade, Inc., [Transfer Binder 1986-1987] Comm. Fut. L. Rep. (CCH) ¶ 23,500 (C.F.T.C. Feb. 11, 1987) (holding that contracts in question fell under the Act’s jurisdiction since evidence established that the parties could not have reasonably expected actual delivery of the underlying commodity and basing its judgement on the standardized nature of the contracts in question and the implication in the seller’s literature that firm would permitted offset); Characteristics Distinguishing Cash and Forward Contracts and “Trade” Options, 50 Fed. Reg. 39,656, 39,657-58 (1985) (listing three requirements to qualify as a contract for deferred delivery: 1) the contract must require delivery of the underlying, 2) the parties must have the capacity to make delivery and 3) delivery must be intended by the parties).
88 680 F.2d 573 (9th Cir. 1982).
89 Id. at 581.
90 Id. at 579.
pectation that Co Petro would actually deliver petroleum products.\(^9\)
Thus, the lesson was that forward contracts not contemplating actual
delivery of the underlying statutory commodity represents the kind of
speculative ventures that Congress intended the Act to govern. App-
parently, the court, with aid from the Commission, taught the lesson
well.\(^2\)

c. A Challenge to the Traditional Model: The Brent Crude Analysis

After years of faithful observance of the traditional model, the
Commission backed away from its rigid adherence in a 1990 admin-
istrative ruling. The controversy involved the purchase and sale of oil
through a fifteen-day Brent contract. Brent contracts were bilaterally
negotiated deals that typically incorporated standard terms and condi-
tions. While the contracts did not explicitly give counterparties the
right to offset, counterparties usually had ample opportunity to nego-
tiate offsetting transactions. On the basis of this substantial opportu-
nity to offset, a federal district court, applying the logic of the tradi-

\(^9\) See id.
1991) (recognizing that courts “have opined [that the deferred-delivery exception] is designed
for purchasers [who] . . . expect to take delivery of the commodity . . . as distinguished from
purchasers who have no expectation of taking delivery of the commodity in the future, but
merely engaged in a speculation on price change”); CFTC v. Trinity Metals Exch., Inc., No. 85-
contract did not qualify for the deferred-delivery exception since “speculation, and not delivery
of the actual commodity, [was] the [underlying] purpose of [the contract]”); NRT Metals, Inc. v.
Manhattan Metals, 576 F. Supp. 1046, 1050 (S.D.N.Y. 1983) (“The exemption referred to is a
narrow one. . . . [The Act encompasses] the notion that a cash forward contract is one in which
the parties contemplated physical transfer of the actual commodity.”) (citations omitted); CFTC
(W.D. Tenn. May 7, 1982) (holding coal purchase agreements as not qualified for the deferred-
delivery exception since investors did not expect delivery of coal); Regulation of Hybrid and
Related Instruments, 52 Fed. Reg. 47,022, 47,023 (1987) (stating that forward transactions
“undertaken principally to assume or shift price risk” without the expectation of “transferring
title” in the underlying commodity do not qualify for the deferred-delivery exception); In re
(C.F.T.C. Aug. 7, 1985) (holding that forward transactions that afford “participants with an
opportunity to assume or shift the risk of price changes in an underlying commodity without the
forced burden of delivery” fall under the Act’s jurisdiction).

Professor Stein has explained the lesson as follows:

neither the [Commission] nor the courts have had difficulty applying the “intent to
deliver” criterion for distinguishing between futures and forwards . . . . Congress
intended to excuse from the otherwise plenary reach of the exchange-trading re-
quirement only a very narrow class of future-settling contracts that contemplate the
transfer of actual ownership of a commodity in a commercial, merchandising trans-
action. Congress apparently concluded that cash deferred contracts, which contem-
plate the transfer of actual ownership of a commodity, could not be used to manipu-
late prices. Conversely, future-settling contracts that did not contemplate actual de-
livery, regardless of the nature of the parties involved, posed a sufficient threat to
require that they be traded only on monitored exchanges.

tional model, held that the fifteen-day Brent contracts did not qualify for the deferred-delivery exception and thus fell within the Act's jurisdiction.93

As Alton Harris has observed, the district court's position in Transnor put the Commission in a difficult position by effectively ruling the fifteen-day Brent market illegal under the exchange-trading requirement. The Commission "could either accept the decision and its implications—namely, to regulate or prohibit the entire Brent market—or reject the Delivery Requirement and permit the Brent market to continue to operate."94 The Commission decided to spare the Brent market, poking a stick into the critical eye of the traditional approach. The Commission opined that since 1) the parties entered into the transaction in connection with their business and 2) the contracts in question contained specific delivery obligations that imposed substantial delivery-related risks, the contracts constituted deferred-delivery contracts beyond the Act's jurisdiction.95 While the opinion did not mark a profound departure from the traditional model, it was significant. The Commission's focus on contractual form defied the admonishment of Stovall that the analysis not emphasize contractual form. Under the Commission's Brent crude approach, a mere risk of delivery, presented by the absence of contractual terms providing for offset rather than an expectation of delivery, was enough, under certain circumstances, to qualify a forward transaction for the deferred-delivery exception. Hence, the Commission exempted Brent contracts from the Act's jurisdiction when it was given statutory authority to do so.96

The Ninth Circuit followed the Commission's cue, taking an analogous approach in Bybee v. A-Mark Precious Metals.97 In Bybee, a precious metals retailer, Bybee, arranged to purchase gold and silver bullion coins for customers from wholesaler, A-Mark. The customers paid Bybee in full; instead of delivering the metals to his customers, Bybee arranged for his customers' metals to be stored with A-Mark. Unbeknownst to the customers, Bybee's arrangement was participation in A-Mark's deferred-delivery plan. Under the plan, Bybee made partial payment to A-Mark and A-Mark agreed to make delivery upon receipt of the balance.98 The balance due was secured by a lien on the

93 See Transnor (Bermuda) Ltd. v. BP North Am. Petroleum, 738 F. Supp. 1472, 1491-92 (S.D.N.Y. 1990) (noting that the fifteen-day Brent contracts "routinely settled by means other than delivery").
94 Harris, supra note 80, at 1131.
97 945 F.2d 309 (9th Cir. 1991).
98 See id. at 311.
undelivered metals purchased under the plan. Essentially, A-Mark’s deferred-delivery plan was a margin account. Thus, as the price of silver fell, A-Mark issued margin calls, which Bybee could not meet. Consequently, A-Mark liquidated Bybee’s $2.1 million position. While Bybee got $300,000 from the liquidation, he owed his customers much more. Bybee tried to make up the difference through commodities speculation, but failed. He eventually declared bankruptcy.

A victim of buzzard’s luck in commodities speculation, Bybee, through his trustee in bankruptcy, petitioned the courts to save him. He sued for rescission on the basis that the deferred-delivery contracts constituted illegal off-exchange futures contracts under the Act. Notwithstanding the fact that the margin contracts provided speculators a vehicle to bet on the price of metals, the Ninth Circuit held that the contracts qualified for the deferred-delivery exception since both parties, acting in connection with their business, had undertaken substantial commercial risk of delivery. Under the plan, “both A-Mark and Bybee had the legal obligation to make or take delivery upon demand of the other.” Like the Brent crude analysis, contractual form trumped subjective intent, even though A-Mark tacitly assured prospective customers that it would offset positions on demand.Offsetting required a separately negotiated agreement for which neither party was under obligation to effect. As in the Commission’s Brent crude opinion, the risk of delivery presented by the absence of contractual terms guaranteeing offset supported the application of deferred-delivery exception, even where participants did not expect such delivery.

d. Reaffirmation of the Traditional Model in the Context of Finite Commodities

Notwithstanding the previous discussion, recent cases have reaffirmed the logic of the traditional model. Often, these cases in-

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99 See id. at 312.
100 See id.
101 See id.
102 See id. at 312-13.
103 See id. at 316-17.
104 Id. at 315.
105 Id. at 315.

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Some lament the traditional model for interpreting the deferred-delivery exception too broadly. See Glenn L. Norris et al., Hedge to Arrive Contracts and the Commodity Exchange Act: A Textual Alternative, 47 Drake L. Rev. 319, 338-39 (1999) (arguing that using contemplated delivery as the analytical lodestar results in an overly broad interpretation of the deferred-delivery exception). Norris and colleagues propose that only transactions involving a sale of goods under U.C.C. § 1-105, rather than contracts for the sale of future goods, properly fall under the exception. Under this approach, the underlying commodity would have to be existing and identified at formation for the contract to qualify for the deferred-delivery exception. Contracts for the sale of future goods, i.e. goods not existing and identified, would not qualify for
volved enhanced hedge-to-arrive ("enhanced HTA") transactions between farmers and grain merchants. In these transactions, farmers generally promise to deliver stated quantities of grain to grain merchants on contractually specified dates. At this point, the farmers are perfectly hedged against grain price volatility because any change in value of the short position created by the promise to sell is exactly offset by the change in the value of the crop. The merchant hedges his long position in the forward contract by taking a short position in a traded grain future of comparable expiration (typically, a futures contract expiring in the same delivery month). Since delivery and the expiration of the future usually do not coincide, the merchant’s hedge is not perfect and, consequently, the merchant bears some basis risk (variation in the difference between spot and futures price) for which farmers generally compensate.

The controversial twist in enhanced HTA contracts is the roll provision. Enhanced HTAs give farmers the right to defer delivery at expiration of the HTA.\textsuperscript{106} The problems start when farmers exercise deferral rights and, subsequently, sell grain originally committed to merchants to take advantage of relatively high prices in the spot market. By exercising deferral rights and selling their crop in the swap market, farmers assume naked short positions in grain. Essentially, the farmers bet that a decrease in grain prices will allow them to purchase cover-grain relatively cheaply.

Unfortunately for farmers undertaking the bet, an unusually prolonged rise in grain prices occurred in the mid-1990s. Enhanced HTAs do not give farmers rights to defer indefinitely.\textsuperscript{107} Farmers engaging in sell-high and cover-low strategies, expecting grain prices to fall according to typical price patterns, lost big as merchants demanded delivery when cover-grain prices were relatively high.\textsuperscript{108} The enhanced HTA cases involved farmers attempts to avoid their losses. Lawyers representing farmers, working to save their clients from huge losses, put on clinics in contractual defense. One of the favored contractual defenses was based on the doctrine of legality.\textsuperscript{109} The farmers’ advocates contended that enhanced HTA constituted illegal, unenforceable, off-exchange futures transactions under the Act since

\textsuperscript{107} See id.
\textsuperscript{108} See id. at 749.
\textsuperscript{109} See id.
the HTA forwards did not qualify for the deferred-delivery exception.\(^\text{110}\)

The federal circuits that have considered the controversy have uniformly rejected the farmers' illegality defense. However, in doing so, the circuits have uniformly reaffirmed the traditional model. In *Lachmund v. ADM Investor Services, Inc.*,\(^\text{111}\) the Seventh Circuit held that the enhanced HTA contract in question qualified for the deferred-delivery exception because the counterparties contemplated actual delivery; thus, contemplated actual delivery was the fundamental factor in interpreting the deferred-delivery exception.\(^\text{112}\) The court reasoned that, in contrast to forward contracts contemplating actual delivery, futures contracts serve as "mechanisms used to shift price risk."\(^\text{113}\) Holding fast to the distrust of risk-shifting transactions inherent in the traditional model, the court suggested that Congress limited the deferred-delivery exception to contracts through which the parties contemplate actual delivery because such transactions "did not present the same opportunities for speculation, manipulation and outright wagering that trading in futures . . . presented."\(^\text{114}\)

Correspondingly, the Sixth Circuit, in *The Andersons, Inc. v. Horton Farms, Inc.*,\(^\text{115}\) held that an enhanced HTA contract qualified for the deferred-delivery exception on the basis of the inherent value of the underlying commodity to the counterparties.\(^\text{116}\) Like the Seventh Circuit, the Sixth Circuit held fast to the traditional model, opining that Congress enacted the Act to control speculative transactions, as distinguished from transactions in commodities having "'inherent value' to the transacting parties."\(^\text{117}\) The court suggested that risk-shifting activity constitutes an abuse akin to market manipulation.\(^\text{118}\) Like the Seventh Circuit, the court considered expected actual delivery.

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\(^\text{110}\) The farmers' position had support in a Commission administrative ruling. See *Competitive Strategies for Agric., Ltd.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. § 27,771 (C.F.T.C. Aug. 24, 1998) (holding that the deferred-delivery exception did not apply to an enhanced HTA contract because, among other things, "the contract provided an effective means of discharge or offset that was, in practice, used routinely to liquidate the contract for cash with no delivery of grain required" and "the contract was marketed, entered into and structured as a means of capturing price movements in the futures markets, not as a vehicle for delivery"). See also Charles F. Reid, Note, *Risky Business: HTAs, the Cash Forward Exclusion and Top of Iowa Cooperative v. Schewe*, 44 VILL. L. REV. 125, 133-37 (1999) (arguing that the enhanced HTA structure might not qualify for the deferred-delivery exception because its features accommodate speculation).

\(^\text{111}\) 191 F.3d 777 (7th Cir. 1999).

\(^\text{112}\) See *id.* at 787-88 ("The document itself will reveal whether the agreement contemplates actual delivery . . . .").

\(^\text{113}\) *Id.* at 786.

\(^\text{114}\) *Id.* (quoting Salomon Forex, Inc. v. Tauber, 8 F.3d 966, 970-71 (4th Cir. 1993)).

\(^\text{115}\) 166 F.3d 308 (6th Cir. 1998).

\(^\text{116}\) See *id.* at 318, 322.

\(^\text{117}\) *Id.* at 318.

\(^\text{118}\) See *id.*
delivery the critical factor in interpreting the deferred-delivery exception.\textsuperscript{119}

The Eighth Circuit’s statement on enhanced HTAs followed this trend, criticizing suggestions that the traditional model be scrapped in favor of a contractually focused test. Following a mocking acknowledgment that focusing on contractual form would make the analysis much easier, the court opined that such a myopic approach would hinder judicial efforts to administer faithfully the “congressional policies underlying the vague text [of the Act].”\textsuperscript{120} The court concluded that adherence to the analytics of the traditional model was necessary to advance the Act’s policy.\textsuperscript{121}

2. The Sotomayor Alternative

While adhering to the idea that Congress intended the Act’s jurisdiction to reach forward transactions executed for speculative purposes, Judge Sotomayor rejected the reliance on contemplated delivery as a proxy for non-speculative intent. Judge Sotomayor argued that transactions executed for hedging purposes should qualify for the deferred-delivery exception even in the absence of contemplated delivery or substantial commercial risk of delivery. Judge Sotomayor employed this approach in \textit{MG Refining and Marketing, Inc. v. Knight Enterprises, Inc.},\textsuperscript{122} which involved an after-effect of MG Refining’s storied marketing debacle.

\textsuperscript{119} See id. See also CFTC v. Noble Metals Int’l, Inc., 67 F.3d 766 (9th Cir. 1995) (holding that counterparties must contemplate actual delivery for a forward transaction to qualify for the deferred-delivery exclusion; forward contracts on precious metals that required the buyer to take title but not actual delivery deemed within the scope of Act); \textit{Salomon Forex}, 8 F.3d at 970-71 ("Transactions in the commodity itself which anticipate actual delivery [do] not present the same opportunities for speculation, manipulation, and outright wagering that trading in futures and options [presents]."); CFTC v. Hanover Trading Corp., 34 F. Supp. 2d 203, 205, 205 n.14 (S.D.N.Y. 1999) ("The lack of an expectation that delivery of the physical commodity will be made is an important factor indicating the presence of a futures contract. . . . A 'cash forward' contract . . . is one in which the buyer enters into the contract in contemplation or expectation of taking physical delivery.") (footnote and citation omitted); Johnson v. Land O'Lakes, Inc., 18 F. Supp. 2d 985, 995 (N.D. Iowa 1998) (holding that the enhanced HTA contract in question qualified for the deferred-delivery exception on the basis that the parties expected delivery since "the contracts, taken as a whole," established a delivery price for grain). \textit{Cf.} 1 TIMOTHY J. SNIDER, \textsc{REGULATION OF THE COMMODITIES FUTURES AND OPTIONS MARKETS} § 9.07, at 9-14 (2d ed. 1995) (observing that the deferred-delivery "exclusion has been narrowly construed to date and it is anticipated that this construction will be continued in the future" and that cash settled forward contracts are likely within the Act’s jurisdiction); Ned Swan, \textsc{Electricity Derivatives Regulation Mired in Uncertainty}, \textsc{Electric Light & Power}, Feb. 1999, at 19 (distinguishing forward contracts from futures contracts with reference to the cash settlement option inherent in futures contracts).

\textsuperscript{120} Grain Land Coop v. Kar Kim Farms, 199 F.3d 983, 992 (8th Cir. 1999).

\textsuperscript{121} See id. (concluding that the analysis must focus on “whether there is a legitimate expectation that physical delivery of the actual commodity by the seller to the original contracting buyer will occur in the future”) (internal quotation marks and citation omitted).

\textsuperscript{122} 25 F. Supp. 2d 175 (S.D.N.Y. 1998).
Following a rather novel marketing strategy, MG Refining agreed to sell customers specified quantities of petroleum every month at a fixed price six to eight cents above market price at contract formation. MG Refining hedged its exposure to oil-price risk with long positions in petroleum futures. MG Refining executives planned that gains in their stacked hedge futures position would offset short-position losses vis-à-vis customers. However, MG Refining executives did not appreciate the effects of funding risk inherent in their plan. When oil prices fell, MG Refining realized the losses from its futures hedge position immediately while the gains from its positions with customers would only be realized over time. Eventually, in late 1993, the losses on the futures positions became so staggering that MG Refining’s parent ordered the liquidation of all futures positions. (The wisdom of MG Refining’s liquidation is controversial. Some assert that the strategy would have succeeded had it been executed to fruition, while others maintain that the strategy was fatally flawed.) Once MG Refining’s futures positions were unwound at a loss of $1.33 billion, MG Refining wished to sever its unhedged commitments to customers by repudiating certain long-term commitments (“flexies”).

In 1994, following the marketing debacle, the enforcement arm of the Commission investigated whether MG Refining’s flexies constituted illegal off-exchange futures contracts. Recognizing an opportunity to avoid its contractual commitments, MG Refining made an offer of settlement, eventually accepted by the Commission. The resulting order, among other things,

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\text{declared the contracts to be illegal off-exchange futures contracts and required MG to certify within five days that it had notified all Purchasers of existing [contracts] that the Commission [had] entered [an order] finding that the [contracts] [were] illegal and therefore void . . . and directing [MG] to cease and desist from violating the relevant sections of the [Act].}
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Happy to cooperate, MG Refining informed its customers that further performance on contracts effected pursuant to the marketing plan was barred by order of the Commission. Nevertheless, MG Refining’s

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123 See Anatoli Kuprianov, Derivatives Debacles: Case Studies of Large Losses in Derivatives Markets, 81 ECON. Q., Fall 1995, at 1, 6-7.
124 See id. at 7.
125 See id. at 7, 13-18.
126 MG Refining, 23 F. Supp. 2d at 178 (sixth and seventh alterations in original) (internal quotation marks and citations omitted).
customers demanded performance.\textsuperscript{127} When MG Refining refused, its customers sued.\textsuperscript{128}

MG Refining's petition asked for summary judgment based on the Commission's order declaring the contracts illegal under the Act.\textsuperscript{129} The customers' summary judgment petition responded that the contracts qualified for the deferred-delivery exception and, thus, were legal under the Act.\textsuperscript{130} The contracts in question were typical forwards with a critical twist—they contained a blow-out provision, giving purchasers the right to cash-out without taking delivery in the event of a price spike. A contractual price spike occurred when the futures price of certain petroleum futures trading on the New York Mercantile Exchange rose higher than the contractually stated price. Although customers were ostensibly committed to take delivery of a significant amount of gasoline or heating oil, only a few actually had the capacity to take physical delivery and no customer ever requested such delivery. The court observed that

although the right to cash out the flexies was triggered only during price spikes, the record contain[ed] ample evidence . . . that the chance of a price spike occurring within the terms of the flexies was objectively very high, and price spikes sufficient to trigger the blow-out provisions did in fact occur in every case.\textsuperscript{131}

The customers' argument was based on a perceived assertion in the Commission's Brent crude opinion and in Bybee that the traditional model had been displaced by a more objective test. They argued that, notwithstanding the intent of the parties, the "contracts should be considered [legal deferred-delivery] contracts whenever they are entered into between commercial parties in connection with their businesses, and when the contracts set forth specific delivery obligations imposing on the parties substantial economic risks of a commercial nature."\textsuperscript{132}

Judge Sotomayor first rejected this argument, concluding that no displacement had occurred, maintaining the customers had overstated the implications of the Brent crude opinion and Bybee.\textsuperscript{133} She criticized the customers' "careless abstraction" of legal principles from the facts that gave rise to them: "[I]t was only in [the] specific context [of the case] that the [Commission] concluded that cashed-out 15-day

\textsuperscript{127} See id.
\textsuperscript{128} See id.
\textsuperscript{129} See id. at 185.
\textsuperscript{130} See id. at 180-81.
\textsuperscript{131} Id. at 185 (footnote omitted).
\textsuperscript{132} Id. at 182.
\textsuperscript{133} See id. at 183.
Brent contracts ought to be considered agreements appurtenant to the more primary goal of obtaining deferred delivery of underlying commodities. Judge Sotomayor held that, instead of suggesting a more contractually focused analysis, the Commission's Brent crude opinion actually affirmed the traditional model's focus on subjective intent in most cases. Limiting the implication of the Brent crude opinion to its facts, she held that the opinion merely suggested that that the use of the anticipated delivery as the analytical touchstone might not be appropriate where the parties do not contemplate actual delivery but nevertheless undertake a substantial commercial risk of delivery:

In fact, far from undermining the traditional forward contract analysis, the CFTC explicitly reiterated the proposition that to identify a forward contract, the transaction[s] must be viewed as a whole, with a critical eye towards [their] underlying purpose. . . . Although the CFTC decided to de-emphasize the importance of routine physical delivery in discerning the purposes of the 15-day Brent contracts, the [Commission] found it particularly salient, in reaching this decision, that the 15-day Brent contracts contained no right of offset, [did] not rely on a variation margining and settlement system, and [did] not permit assignment of contractual obligations without counterparty consent. The CFTC decision thus indicated its expert opinion that contracts containing no rights to offset, but that are nevertheless cashed out pursuant to separately negotiated agreements, should not be deemed to serve a speculative purpose just because they do not end in physical delivery.  

Judge Sotomayor disposed of Bybee similarly, maintaining that the Ninth Circuit had "second[ed] the proposition . . . that when contracts for future delivery give neither party a right to cash out, but are still cash settled pursuant to independently negotiated agreements, absence of physical delivery alone should not be deemed to imply that the contracts served merely speculative purposes." While she doubted that anticipated delivery should be the analytical touchstone for determining qualification for the deferred-delivery exception in all cases, Judge Sotomayor reaffirmed the principle that the underlying purpose of a transaction is "the touchstone of the forward contract analysis."

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134 Id.
135 Id. at 183-84 (alterations in original) (internal quotation marks, citations, and footnote omitted).
136 Id. at 184.
137 Id.
After rejecting the customers’ analysis of the implications of Brent crude and Bybee, Judge Sotomayor considered whether the contract in question qualified for the deferred-delivery exception. She rejected the customers’ argument that contracts qualified for the exception as a matter of law. In denying customers’ summary judgment motion, Judge Sotomayor applied the logic of the Brent crude opinion, distinguishing the contacts in question from the Brent contracts and the margin contracts in Bybee on the basis of the differential in commercial risk presented. The contracts in question gave customers the right to offset upon the occurrence of a highly probable condition. Moreover, uncontested evidence established that, even in the extremely unlikely event that the price spike condition did not occur, MG Refining “indicated in its sales pitches that the flexies would . . . be ‘rolled over’, and their terms extended” until such time that a blow-out occurred. Finally, uncontested evidence established that most customers utilizing flexies lacked the capacity to take physical delivery of petroleum product and, in fact, no customer ever requested such delivery. To Judge Sotomayer, the risk of physical delivery was clearly negligible. In contrast, the Brent contracts afforded the counterparties no right to offset, contingent or otherwise; offset would have required a separately negotiated agreement. Thus, the Brent crude market “remain[ed] one based on physical trading” that required participants to undertake “substantial risk[s] of a commercial nature, including those of demurrage, damage, theft or deterioration of the commodity as well as other risks associated with owning the commodity delivered.” Analogously, Bybee could have only gained a right of offset from A-Mark though additional dickering. Judge Sotomayer determined from the uncontested evidence that the customers neither contemplated actual delivery nor faced a substantial risk of such delivery.

Under such circumstances, a court using the traditional model would have granted MG Refining’s summary judgment. However, Judge Sotomayor denied MG Refining’s motion, refusing to expose the contracts in question to the Act’s jurisdiction on the sole basis of a lack of contemplated delivery and an insubstantial risk of delivery. In doing so, Judge Sotomayor effectively rejected the traditional model. She maintained that forward contracts qualify for the deferred-delivery exception when such contracts are “entered into primarily as ways of shifting future price risks incidental to commercial operations and other forward commitments” rather than “to speculate on an unregulated futures market price, thereby obtaining a second source of

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138 See id.
139 Id. at 186.
140 Id. at 183 (alterations in original) (internal quotation marks omitted).
141 See id. at 188.
income.” She determined that the speculative purposes issue was a question of fact appropriate for jury resolution.

The traditional model carries the policy crusade against speculative dealing so far that any risk-shifting transaction is deemed to be “speculative,” even if the actual purposes involve hedging or arbitrage. While accepting the anti-speculation bias, Judge Sotomayor rejects the anticipated delivery proxy. Her approach would require courts to make explicit inquiry into nature of the forward transactions to determine such transactions were executed primarily for hedging purposes.

3. The Easterbrook Model: Nagel v. ADM Investor Services, Inc.

Acceptance of the idea that interpretation of “contract for future delivery” turns on subjective intent, whether determined by proxy or actual analysis, is not universal. Judge Easterbrook, sitting by designation in federal district court, issued a stinging rebuke to the proposition that all executory contracts, except those qualifying for the deferred-delivery exception, fall within the Act’s jurisdiction. Nagel v. ADM Investor Services, Inc. involved enhanced HTA deals gone bad—farmers looking to avoid performance by characterizing the contracts in question as illegal off-exchange futures contracts. Unlike other courts, Judge Easterbrook did not focus on the deferred-delivery exception. Rather, his analysis focused on whether the enhanced HTAs under consideration constituted contracts for future delivery at all.

Judge Easterbrook’s iconoclastic approach was unnecessary to his holding that the contracts in question were beyond the Act’s jurisdiction. He could have reached the same conclusion applying the traditional model. Yet the Commission had suggested aggressive regulation of OTC derivative markets. While he did not explicitly say so, it may be that Judge Easterbrook realized that under the logic of the traditional model, the Act’s jurisdiction would envelop the OTC derivatives markets, and he took the opportunity to offer an alternative model of the Act’s jurisdiction.

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142 Id. at 188.
143 See id. (holding that a jury question remained not only as to the contractual language, but also as to the facts surrounding negotiations).
145 See id. at 748 (noting that the “centerpiece of the suit” was whether the enhanced HTA contracts were futures contracts).
146 See id. at 751 (stating a strong inclination to reach the same holding under the traditional model).
Judge Easterbrook offered three doctrinal justifications for his rejection of the traditional model and, implicitly, Judge Sotomayer’s alternative. First, he suggested that courts employing the traditional model misread the Act. The traditional model assumes “that every contract for delivery in the future is a ‘contract for future delivery’ and therefore must be traded as a futures contract, and then turn[s] to the [deferred-delivery] exception.”148 This approach, wrote Judge Easterbrook, assumes that the term has a “lay rather than a technical meaning.”149 Alternatively, he reasoned that “the language has a technical reference – that the statute specifies the kind of contracts that trade in futures markets.”150

Judge Easterbrook thought a technical interpretation appropriate because the popular lay interpretation implied an absurdly broad reading of the Act’s jurisdiction.151 To illustrate his point, he asked the reader to imagine a world under the Grain Futures Act (“GFA”), the predecessor to the Act: “Can it be that until 1936 all commercial contracts for future delivery of newspapers, coal, ice, oil, gas, milk, bread, electricity, and so on were unlawful futures contracts?152 Answering his own question, he concluded: “Surely the answer is no, which means that ‘contract for future delivery’ must have a technical rather than a lay meaning.”153 The problem with the illustration is that it assumes wider jurisdictional scope for the GFA than the Act actually had. Congress limited the scope of the GFA to certain enumerated grains.154 It did not extend to the commodities mentioned by Judge Easterbrook. Due to the narrow scope of commodity under the GFA, the lay interpretation of “contract for future delivery” would not have had the absurd implications it has today. The truly absurd implications arise from the 1974 Act, which amended “commodity” to include virtually anything that might form the subject matter of a forward contract.

When one considers the institutional capacity of the Commission, the soundness of Judge Easterbrook’s argument is apparent. Under the traditional model, most OTC derivatives would fall under the Act’s jurisdiction because, prior to the enactment of the Modernization Act, the traditional model extended the Act’s jurisdiction to all cash-settled forward transactions that did not qualify for the deferred-

148 Nagel, 65 F. Supp. 2d at 751.
149 Id.
150 Id. (emphasis added).
151 See id.
152 Id.
153 Id.
154 See supra note 7.
delivery exception. Essentially, Judge Easterbrook argued that a reading of "contract for future delivery" that would theoretically, if not in practice, expose much of the OTC derivative market to the Act's jurisdiction simply cannot be right. The Commission is a relatively small agency, institutionally incapable of policing the OTC derivative markets, as its chairman admitted while supporting a report that recommended explicit statutory limits on the Commission's power to regulate such markets. Moreover, important policy makers argue that the Commission's technical competence is limited to futures trading on finite commodities, especially agricultural commodities. In this vein, Alan Greenspan brushed off the Commission's role in financial regulation. The upshot is that a reading of the Act that implies a regulatory scope for the Commission far beyond its capacity is unreasonable. At least, the technical interpretation advocated by Judge Easterbrook would have bound the Commission to the limits of its competence. The broad exemptions for financial derivatives enacted though the Modernization Act suggest that this view has achieved critical salience.

Judge Easterbrook also deemed the use of intended delivery as "the defining characteristic" of an exempt forward contract "implausible." He noted that all futures contracts, like OTC forwards, require future delivery of the underlying commodity. Use of intended delivery as a jurisdictional touchstone creates indeterminacy because it "treats as the dividing line something the two forms of contract have in common—not only in the statutory text but also in the commercial world." Proponents of the traditional model argue that, while parties to futures contracts have the right to make or take delivery, less than three percent actually do so. While this is so, Judge Easterbrook noted that institutional differences explain the differential

155 See Nagel, 65 F. Supp. 2d at 754 (criticizing the Norris, Davidson, and May argument that only contracts on commodities identified at formation qualify for the deferred-delivery exception).
156 See Dean Anason, Futures Commission Head: OTC Oversight Unnecessary, AM. BANKER, Dec. 8, 1999, at 2 (arguing that the Act was not designed to regulate OTC derivatives).
159 Nagel, 65 F. Supp. 2d at 751.
160 Id.
rates of settlement by delivery. 161 A better approach, according to Judge Easterbrook, involves a comparison of institutional characteristics. Accordingly, courts need not “depart from the technical understanding of a futures contract, and much mischief has been caused by the attempt.” 162

Finally, Judge Easterbrook rejected the traditional model because of the legal uncertainty it inspired. William J. Rainer, Commission chairman, admitted that legal uncertainty was a problem in the OTC derivative markets and that the establishment of “clear legal certainty” was imperative to achieving “[t]he national interest in fostering economic efficiency and competition in the OTC derivatives market.” 163 Judge Easterbrook explained the effect of legal uncertainty in the capital markets:

It is essential to know beforehand whether a given contract is a futures or a forward. The answer determines who, if anyone, may enter into such a contract, and where trading may occur. Contracts allocate price risk, and they fail in that office if it can’t be known until years after the fact whether a given contract was lawful. 164

Judge Easterbrook thought that misreading “contract for future delivery” was at the heart of legal uncertainty in the OTC derivative markets. 165

b. Support in Case Law for the Easterbrook Approach

While the traditional model achieved widespread acceptance in cases involving forward contracts on finite commodities, it does not appear to be salient in the relatively few cases analyzing forward contracts on non-finite commodities. Intangible commodities entails those “services, rights, and interests” capable of being the subject matter of a forward-type contract within the scope of the Act as a result of the 1974 Act. 166 Some courts have been willing to rely on a technical understanding of futures contract in analyzing whether the Act’s jurisdiction extended to the transactions in question. 167

161 See id. at 754 (applying an analysis of institutional differences to the enhanced HTA contracts in question).
162 Id.
163 Anason, supra note 156, at 2.
164 Nagel, 65 F. Supp. 2d at 752.
165 See id. (reasoning that the traditional model “produces undesirable uncertainty”).
167 Such an approach had additional support in commentary. See, e.g., JERRY MARKHAM, THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION 233 (1987) (arguing that standardized and easily offset swap agreements should be subject to the Act due to their similarity to futures contracts); Willa E. Gibson, Are Swap Agreements Securities or Futures?:
1. *Chicago Mercantile Exchange v. SEC.* The Seventh Circuit implicitly employed Easterbrook's approach in *Chicago Mercantile Exchange v. SEC.* In that case, the Chicago Mercantile Exchange challenged the SEC's approval of stock exchange-traded "index participations" ("IP") on certain exchanges regulated by the SEC. IPs were contracts of indefinite duration whose value derived from securities indexes such as the S&P 500 or the Dow Jones Industrial Average. The case turned on whether IPs constituted contracts for future delivery, since, under the Act, the Commission had exclusive jurisdiction over such contracts. Unfortunately for all involved, IPs did not fit neatly into any extant regulatory paradigm.

On one hand, buyers of IP contracts paid cash on the day of sale in exchange for a promise by the seller to pay a quarterly cash flow based on dividends paid on the stocks underlying the index to which the IPs were tied and to allow buyer to cash-out of the IP on predetermined days. From the buyer's perspective, the court noted that IPs had "properties similar to those of a closed-end mutual fund holding a value-weighted portfolio of the securities in the index: the IPs last indefinitely, pay dividends, and may be traded freely; on cash-out day the IP briefly becomes open-end, and the investor can withdraw cash without making a trade in the market." On the other hand, the court noted sellers "saw the IP as a speculative or hedging instrument scarcely distinguishable from a futures contract that terminates on the cash-out day, plus an option held by the long to roll over the contract to the next cash-out date." Comparing the difficulties raised by the issue to difficulties one would encounter in deciding whether "tetrahedrons belong in square or round holes," the Seventh Circuit concluded that the IPs were similar enough to standardized exchange-, cash-settled futures contracts to fall within the Act's jurisdiction and, thus, the Commission's regulatory purview.

forward contract on Government National Mortgage Association issued mortgage-backed securities that called for settlement four months after the contract date. The controversy arose when the market value of the securities declined due to the increase in mortgage prepayments precipitated by a decline in interest rate volatility. The plaintiff complained that Oppenheimer misrepresented the sensitivity in the value of the securities to a decline in interest rates and invoked, among other things, the anti-deception provisions of the securities laws. The Seventh Circuit accepted the case to determine whether a forward contract on securities constituted a "purchase or sale" of a security.

Defendants, looking to establish the jurisdictional exclusivity of the Act, argued that securities laws did not apply because the forwards in question were indistinguishable from exchange-traded futures. While the court noted that retail customers routinely executed such transactions to speculate on the price of the securities, the court distinguished the forward transaction in question from futures mainly on the basis that the forwards were bilaterally negotiated rather than standardized instruments. Moreover, the court, anticipating the Commission's Brent crude logic, stated that a mere possibility of a negotiated offset did not compel a finding that the contract in question constituted a futures contract. The critical aspect of Abrams is the rejection of speculative intent as a criterion for decision and its focus, albeit far from rigorous, on the institutional differences between forwards and futures.

B. The Status of Interest Rate Swaps Under the Act Prior to the Commodity Futures Modernization Act

I. Analysis Under the Traditional Model

Prior to enactment of the Modernization Act, cash-settled forward transactions generally fell within the Act's jurisdiction via the traditional model because parties to such contracts cannot by the nature of the transaction contemplate actual delivery of a statutory commodity, including interest rate swaps. Thus, OTC interest rate

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176 See 7 U.S.C. § 2(1) (2000) ("The [Commission] shall have exclusive jurisdiction . . . over transactions involving contracts for the sale of a commodity for future delivery . . . ").
177 See Abrams, 737 F.2d at 584.
178 See id. at 590 (noting that unlike standardized instruments, "[f]orward contracts allow purchasers to negotiate, inter alia, the quantity of the commodity . . . the time and place of delivery, the manner of payment, and deposit or margin requirements").
179 See id. at 591 n.12 (stating that the sale and delivery of these securities are not prerequisites to the formation of a contract).
swaps not qualifying for the administrative safe harbor would have violated the exchange-trading requirement of the Act and been unenforceable in contract. Moreover, participants in such transactions would have been exposed to civil penalties, criminal penalties, and private suits. Even swaps enjoying the grace of the regulatory safe harbor exemption would have been subject to Commission policing pursuant to the anti-fraud provisions of the Act.

Since subjecting OTC swap contracts to analysis under the traditional model would have had significant negative implications for the continued efficacy of that market, application required strong justification. Such justification was lacking. First, the suspicion of risk shifting at the heart of the traditional model draws its strength from rather dubious historical and economic frameworks. Second,

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180 See supra note 8 and accompanying text.
181 See supra notes 11-13 and accompanying text.
183 See, e.g., Lynn A. Stout, Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives, 48 DUKE L.J. 701, 705 (1999). Professor Stout maintains that the Act embodies the spirit of old common law antipathy toward speculative forward dealings, asserting the Act "reincarnates, in modified statutory form, the common law rule requiring contracts of sale for future delivery to be settled by actual delivery." Id. at 722. Jerry Markham captures the anti-speculation bias in his explanation of the 1974 Act. He maintains that Congress enacted the 1974 Act in reaction to the perception that the old regime could not effectively protect the public against speculators and manipulators. See Markham, supra note 56, at 14 n.49. In addition, wild volatility in commodities prices of the 1970s fueled that perception. As food prices fluctuated violently in the wake of the Bretton Woods collapse, and investors in commodity options lost millions in a series of high profile brokerage failures, public interest activists blamed underhanded dealers and speculative traders for the turmoil. See id. The Des Moines Register, a voice for farm interests, captured the zeitgeist in a series of articles attacking the Act as an inadequate guardian of the public interest against self-interested speculators. See MARKHAM, supra note 167, at 58-59.

But consider another explanation offered from the public choice perspective. While anti-speculation sentiment appeared to have provided some impetus for the first federal commodity futures legislation, proponents of the public choice explanation argue that the attack on speculation provided cover for the strategic aims of farm groups. Following the post-World War I collapse in grain prices, farm interests came to support the idea of cooperative enterprise to support grain prices. Professor Romano posits that the agricultural interests ultimately moved against futures markets to protect the expected monopolistic profitability of the burgeoning farm cooperatives. See Roberta Romano, The Political Dynamics of Derivatives Securities Regulation, 14 YALE J. ON REG. 279, 309-10 (1997). Strategically, then, a desire among farm interests to enjoy the fruits of market power lies at the heart of farm interests' drive for a federal "regulatory toehold" over futures markets. See id. at 309-12.

Regarding the 1974 Act, Professor Romano posits that the farm interests who attacked futures trading did so preemptively to forestall legislation in response to consumer anxiety over volatile food prices that could harm their interests. See id. at 334-35. Unlike previous attacks on futures markets, farm interests' assault on the futures market in the 1970s was muted, even ambivalent, and did not provide a substantial impetus for the enactment of the 1974 Act. See id. at 335. Romano presents evidence that "legislators and self-described consumer advocacy groups" provided decisive impetus, asserting that political gaming explains enactment of the 1974 Act. See id. At the time, federal legislators did not grasp the significance of extending the scope of the Act to non-consumable commodities. See id. at 337 (noting that "few witnesses . . . testifying on the advisability of the amendment foresaw that the market would shift dramatically away from a predominance of agricultural products in a few years"). The creation of an
concern over systemic risk did not justify aggressive Commission policing of the OTC swap market since systemic risk is better dealt with at an entity, rather than transactional, level. Third, price manipulation is not relevant for swap transactions involving non-finite

independent agency was thought to be the critical aspect of the 1974 Act. Professor Romano reasons that the measure appealed to a majority of federal legislators because “it strengthened congressional control of public policy, and in particular that of the Democratic majority, against that of the Republican administration. Creating an independent agency was an attempt to leverage congressional influence in an era of divided government.” Id. at 330. Thus, the argument that Congress intended that OTC derivatives fall within the Act’s jurisdiction does not bear scrutiny.

See, e.g., Stout, supra note 183, at 741-45. For example, Professor Stout offers a noise trading model, dubbed the heterogeneous exceptions model, to explain much activity in the OTC derivative markets. The model assumes that pure differences in belief, as distinguished from hedging or arbitrage activity, motivate a substantial subset of trades in the financial markets. Professor Stout argues that disagreement-based trading is a zero-sum endeavor. When transaction costs are considered, the disagreement-based trades impose deadweight losses on the economy. Accordingly, Professor Stout concludes that a “sophisticated analysis of the derivatives market that incorporates the lessons of the HE model . . . offers the unsettling prediction that derivatives trading can be the source of efficiency losses as well as efficiency gains” and provides normative support for aggressive Commission regulation of the OTC swap market on the basis that some authority or mechanism is need to suppress wealth reducing activity while promoting wealth enhancing activity. Id. at 773. According to Professor Stout, aggressive Commission oversight of derivatives trading might produce welfare gains by sifting out such trading. See id. at 785.

Professor Stout also cleverly appeals to the casino economics criticism of financial markets. See Lynn A. Stout, Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation, 81 VA. L. REV. 611, 661-77 (1995) (arguing that active financial management imposes dead weight economic loss on the economy). Yet Professor Stout’s argument in relation to the OTC derivative markets is unsatisfying because it offers no means of distinguishing pure disagreement-based dealing from risk-shifting or arbitrage activity dealing. Consequently, Professor Stout shies away from an explicit call for aggressive regulation, instead proposing a legal regime where OTC derivative contracts would be unenforceable but where counterparties would not exposed to criminal or civil penalties. See Stout, supra note 183, at 782-83. According to Professor Stout, such a regime would function as a proxy discouraging pure disagreement-based trades while not inhibiting salutary market activity. See id. Professor Stout’s inability to directly distinguish pure disagreement-based trades from other types of trades in the OTC derivative markets suggests that the volume of pure disagreement-based trades is quite small.

Judge Posner reasons that the liberty to speculate provides positive welfare benefit in that speculators play a critical role in mitigating the effects of information failure on asset prices. See RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 140 (5th ed. 1998) (“[S]peculation . . . , by giving people . . . a stake in forecasting prices correctly even though they are not involved in producing or consuming the commodity traded in the market, increases the amount of price information in the market.”). “[S]peculation,” he writes, “serves the salutary purpose of enabling the rapid adjustment of prices to current values. The speculator is an eager searcher for undervalued and overvalued [investments]. The information that he uncovers diffuses rapidly throughout the market . . . , enabling other traders to adjust swiftly to the changed conditions that he has discovered.” Id. at 487. In a market populated by sophisticated actors, trading motivated by factors other than risk-shifting likely results from traders looking to take advantage of subtle information asymmetries that result from proprietary modeling or differences in institutional experience.

See Gibson, supra note 167, at 413-15 (maintaining that policy makers should follow a market participant-based rule).
commodities. Finally, sophisticated swap counterparties possess the understanding and the wherewithal to obtain pertinent financial information in the negotiation process and to protect themselves adequately in contract from deceptive practices.

2. Analysis Under the Sotomayor Alternative

While Judge Sotomayor’s approach would not have subjected all OTC swap transactions to the Act, it would have perpetuated legal uncertainty in the OTC swap market. Sotomayor’s approach did not extend the Act’s jurisdiction to any executory contract that contemplated delivery, involved a substantial commercial risk of delivery, or effected a hedging strategy. Thus, interest rate swap transactions effected for hedging purposes would be beyond the Act’s reach. The approach would have perpetuated legal uncertainty in the OTC swap market, however, by subjecting swaps effected for arbitrage or risk-amplifying purposes to the Act’s jurisdiction. While Judge Sotomayor’s willingness to make a real effort to analyze the economic purpose was laudable, her approach advanced a rather dubious antipathy toward risk-amplifying transactions. Moreover, Judge Sotomayor’s approach offered little guidance in distinguishing risk-amplifying transactions from hedges beyond an admonition that exempt transactions be executed primarily for hedging purposes. In practice, many swap participants only partially hedge, simultaneously taking a position on a view. Others use swaps to amplify their exposure to interest rates, hoping to make use of superior information to reduce the cost of debt. Thus the Sotomayor approach would potentially have subjected a significant proportion of OTC swap market activity to the Act’s jurisdiction, rather than securing legal certainty in the OTC markets.

3. Analysis Under the Easterbrook Approach

The Easterbrook approach offered the best alternative to mitigate legal risk in the OTC swap market. Judge Easterbrook proposed that “contract for future delivery” entails only contracts having institutional characteristics similar to exchange-traded futures contracts. The fact that such an interpretation is consistent with the Commission regulatory capacity suggests that Judge Easterbrook’s interpretation is sound. OTC swaps, including standardized vanilla transactions, are easily distinguished from exchange-traded futures. Whereas futures exchanges do not allow negotiation of terms except for price, OTC

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See id. at 411 (arguing that the purpose of the Act is to prevent manipulation of the commodities markets and reasoning that since most of the commodities that underlay OTC derivatives transactions are abundant, potential market manipulation is not a problem and, thus, the Commission has little justification in regulating OTC derivatives markets).
swap participants may freely negotiate variations to terms contained in the paradigmatic ISDA master agreements.\textsuperscript{187} OTC swaps, unlike exchange-traded futures, are not periodically marked-to-market.\textsuperscript{188} This difference manifests itself economically as convexity bias.\textsuperscript{189} Finally, OTC swap participants generally do not execute swaps through clearinghouse institutions.\textsuperscript{190} Accordingly, interpreting "contract for future delivery" technically would have precluded application of the Act's jurisdiction to OTC swaps.

\section*{C. Administrative Attempts to Deal with the Act's Jurisdictional Ambiguity}

\subsection*{1. The Commission's 1989 Safe Harbor Statement}

Commission regulators first recognized the OTC swap market in 1987 by announcing that the Act's jurisdiction extended to most swap transactions.\textsuperscript{191} Despite its assertion on the jurisdictional scope of the Act, the Commission took a passive no-action attitude toward OTC swap activity, even suggesting that Congress codify its approach.\textsuperscript{192} The Commission's passive-aggressive tact provoked harsh reaction from market participants and other financial regulators\textsuperscript{193} because the assertion implied that OTC swap transactions violated the exchange-trading requirement of the Commission and, thus, were unenforceable.\textsuperscript{194} On the other hand, a few commentators supported the Commission's aggressive jurisdiction claim but complained that the Commission had no authority to take a no-action position.\textsuperscript{195}

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{187}] See supra Part I.B.2.a.
\item[\textsuperscript{188}] See supra Part I.B.2.b.
\item[\textsuperscript{189}] See id.
\item[\textsuperscript{190}] See supra Part I.B.3.
\item[\textsuperscript{191}] See Regulation of Hybrid and Related Instruments, 52 Fed. Reg. 47,023 (1987) (to be codified at 17 C.F.R. pt. 34) (noting that with the exception of three types of hybrid transactions, most swap transactions are subject to the Act).
\item[\textsuperscript{192}] See id.
\item[\textsuperscript{193}] See CFTC to Vote on Publishing Revised Rules for Hybrid Products, SEC. WK., Dec. 12, 1988, at 6 (reporting accusations of Commission overreaching).
\item[\textsuperscript{194}] See CFTC Urged to Scrap Ban on 'Hybrids', L.A. TIMES, Apr. 12, 1988, at 22 ("[The Commission's proposal] has . . . generated uncertainty among market participants with respect to a wide variety of transactions, including interest rate swaps.") (quoting George Gould, former Undersecretary for Finance, Department of Treasury). The Treasury Department sent the Commission a letter in April 1988 stating that "the proposal concerning off-exchange instruments had caused legal uncertainties that may cause serious problems in the swap markets and other large institutional markets." Id.
\item[\textsuperscript{195}] See, e.g., Stein, supra note 92, at 503. At the time, the Act did not explicitly afford the Commission exemptive authority. Professor Stein, believing that that swaps constituted "off-exchange futures" and that the anti-speculation policy of the Act provided normative grounds for Commission regulation of the OTC swap market, argued that the Commission should not "ignore its congressional grant of jurisdiction and concomitant obligation to prohibit off-exchange futures" simply because "the advantages of off-exchange futures trading outweigh its disadvantages." Id.; see also Young & Stein, supra note 53, at 1919 n.14 ("The CFTC lacks
The Commission's explicit jurisdictional assertion did not last. Two years after its initial assertion, the Commission backed off, opining that most swap transactions are not "appropriately regulated" under the Act since "swaps generally have characteristics, such as individually tailored terms, predominantly commercial and institutional participants, and expectation of being held to maturity, rather than offset during the term of the agreement, that may warrant distinguishing them from futures contracts." The Commission followed-up by crafting a safe harbor for swap transactions "consistent with policies reflected in the Act's jurisdictional exclusion for forward contracts" to mitigate the market insecurity wrought by the 1987 jurisdictional statement. To qualify for safe harbor, swaps had to be bilaterally negotiated agreements that did not contain an exchange-style right of offset. Moreover, qualifying swaps could not be executed through a clearinghouse or provide for a marking-to-market mechanism. Finally, qualifying swaps had to be related to the line of business of the transacting counterparties and could not be marketed to the public.

Notwithstanding the safe harbor policy, uncertainty remained. The Commission's justification for the safe harbor policy appeared to
clash with logic of the dominant traditional model. Recognizing this, the Commission attempted to reconcile the inconsistency with the argument that the safe harbor policy embodied the spirit of the Act notwithstanding its appearance. However, the argument did little to reassure market participants. Moreover, the Commission had no explicit exemptive power under the Act. Thus, while the Commission may have been willing to refrain from regulating OTC swaps, swap market participants were wary of the risk that swap contracts might be held unenforceable in private suits.


Congress addressed the issue with its enactment of the Futures Trading Practices Act of 1992 ("FTPA"). Purportedly acting to "promote responsible economic or financial innovation and fair competition," Congress begged the fundamental question of jurisdictional scope. Instead of explicitly defining the jurisdictional scope of the Act, it passed the buck to the Commission by granting it discretionary authority to exempt certain transactions from specific Act provisions.

The FTPA granted the Commission limited exemptive power. First, it allowed the Commission to exempt swap transactions that were "not part of a fungible class of agreements that are standardized as to their material economic terms, to the extent that such agreements may be regarded as subject to the provisions of this chapter." Second, the Commission had to impose a statutorily defined suitability requirement. Third, exemptions had to meet a public-purposes

204 See Harris, supra note 80, at 1127 (arguing that the delivery requirement put the Commission "on a clear collision course" with the OTC derivatives market).
205 See Policy Statement Concerning Swap Transactions, 54 Fed. Reg. at 30,695 ("Although [the] jurisdictional and exemptive or exclusionary provisions [of the Act] are not sufficiently broad to provide clear exemptive boundaries for many swaps, [those provisions] reflect policies relevant to the safe harbor policy . . . and may encompass certain swap transactions.").
206 Prior to the enactment of the Futures Trading Practices Act of 1992, 7 U.S.C. § 6 (2000), the Act "neither contemplated off-exchange futures nor provided the Commission with exemptive rulemaking powers to allow commercial parties to engage in futures [trading] off-exchange." Barry W. Taylor, Swaps: Commodities Laws in Transition, in ADVANCED SWAPS AND DERIVATIVE FINANCIAL PRODUCTS 45, 46 (Daniel P. Cunningham ed., 1991). Taylor reasons that "[w]ithout exemptive rulemaking powers for futures, the CFTC [was] unable to remove the risk under federal law that courts could void swaps as illegal off-exchange futures." Id. at 46.
208 Id. § 6(c)(1).
209 See id.
210 See id. § 6(c)(5)(B). The language of this provision reflects Congress's unwillingness to consider the fundamental jurisdictional question.
211 See id. § 6(c)(2)(B)(i) (providing that the Commission may only exempt swaps transactions between "appropriate persons as defined in 7 U.S.C. § 6(c)(3)").
Finally, the Commission could not grant exemptions that would materially affect "the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under [the Act]."

Pursuant to the FTPA, the Commission in 1993 issued a safe harbor exemption that shielded many swap transactions from certain provisions of the Act. However, to qualify for safe harbor, the swap transaction had to meet certain criteria. First, the swap had to be a non-standardized transaction between "eligible swap participants." Moreover, it could not be executed through a clearinghouse, and credit risk had to be a material part of counterparty deliberations. Unlike the 1989 safe harbor statement, however, the 1993 safe harbor policy allowed the exempted swap agreements to include certain netting arrangements aimed at mitigating counterparty credit risk or other arrangements aimed at mitigating systemic risk.


While the swap market has enjoyed fantastic growth since codification of the 1993 safe harbor policy, legal risk continued to lurk. The problematic feature of the 1993 safe harbor policy was that, in restricting safe harbor treatment to non-standardized swap transactions where credit risk was a material aspect of the negotiations,

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212 See id. § 6(c)(2)(A) (providing that any administrative exemption must be "consistent with the public interest and the purposes of [the Act]").

213 Id. § 6(c)(2)(B)(ii).


215 See id. § 35.2(b) (requiring that the swap not be "part of a fungible class of agreements that are standardized as to their material economic terms").

216 Id. § 35.2(a).

217 See id. § 35.2(d) (requiring that the "swap agreement is not entered into and traded on or through a multilateral transaction execution facility"). See also Exemption for Certain Swap Agreements, 58 Fed. Reg. 5587, 5591 (1993) ("[T]he exemption does not extend to transactions that are subject to a clearing system where the credit risk of individual members . . . 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.").

218 See § 35.2(c) (requiring that the "creditworthiness of any party having an actual or potential obligation under the swap agreement would be a material consideration in entering into or determining the terms of the swap agreement, including pricing, cost, or credit enhancement terms of the swap agreement").

219 See Exemption for Certain Swap Agreements, 58 Fed. Reg. at 5591 ("Under the [revised] proviso, bilateral arrangements for the netting of obligations to make payments or transfers of property . . . would be permitted. Multiparty netting arrangements would also be permitted, provided that the underlying gross obligations among the parties are not extinguished until all netted obligations are fully performed.").

220 See id. ("By expanding the ability of swap participants to utilize collateral and margin arrangements beyond that which is explicitly permitted under the Policy Statement, these rules should promote arrangements that will reduce risk within the financial system.").

221 See 17 C.F.R. § 35.2(b) (requiring that the swap not be "part of a fungible class of agreements that are standardized as to their material economic terms").
the policy embodied the structural ambiguity of statutory "contract for future delivery" framework. Market sensitivity to such risk heightened following the Commission's aborted effort to assert itself as an active regulator of the OTC swap market. In response to market skittishness, the President's Working Group on Financial Markets, composed of the four federal financial regulators, unanimously recommended that Congress amend the Act to explicitly exclude bilateral transactions between sophisticated parties involving non-finite financial commodities. Congress enacted the recommendation as part of the Modernization Act. Prior to enactment of the Modernization Act, the Commission had promulgated a "new regulatory framework" that mirrored the President's Working Group's recommendation. Under the now-obsolete framework, the Commission generally extended safe harbor to all contracts, agreements, and transactions meeting certain conditions. According to the Commission, a majority of the comments on the new framework "expressed the view that the [new framework] . . . would increase legal certainty for the OTC market." Yet legal risk under the framework would have been considerable.

a. Revised Part 35 Would Have Inadequately Mitigated Legal Risk in the OTC Swap Market

1. Safe Harbor Limitations in Revised Part 35. The Commission's abolishment of the non-standardization condition of the old regime would have been the critical innovation of revised Part 35.\(^{227}\)

\(^{222}\) See id. § 35.2(c) (requiring that the "creditworthiness of any party having an actual or potential obligation under the swap agreement would be a material consideration in entering into or determining the terms of the swap agreement, including pricing, cost, or credit enhancement terms of the swap agreement").

\(^{223}\) See The President's Working Group on Financial Markets Report on Over-the-Counter Derivatives Markets and the Commodity Exchange Act: Hearing before the Subcomm. on Risk Management, Research, and Specialty Crops of the Comm. on Agriculture, 106th Cong. 17 (2000) ("Bilateral swap agreements . . . entered into by eligible swap participants . . . should be excluded from [the Act]. . . . The exclusion should not extend to any swap agreement that involves a non-financial commodity with a finite supply.").


\(^{225}\) See id. at 78,035.

\(^{226}\) Id. at 78,031.

\(^{227}\) See id. at 78,035. The Commission complemented revised Part 35 with revised Part 36, which would have provided for the legal execution of swap transactions on "multilateral transaction execution facilities." See A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations, 65 Fed. Reg. at 77,967 (defining multilateral transaction execution facilities as "electronic or non-electronic market[s] or similar facilit[ies] 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 facility") (internal quotation marks and citation omitted).
The problem was that the Commission might have exceeded its statutory exemptive discretion in promulgating it. The Act granted the Commission discretion to exempt only swap agreements "not part of a fungible class of agreements that are standardized as to their material economic terms, to the extent that such agreements may be regarded as subject to the provisions of [the Act]."\(^{228}\) Since revised Part 35 would have exempted those interest rate swaps "standardized as to their material economic terms," one might have argued that extending safe harbor treatment to them was improper. To this, one might have countered that standardization meant the enforced standardization characteristic of futures exchanges. The issue would likely have been a source of uncertainty among OTC swap participants.

Moreover, revised Part 35 contained the statutorily required condition that the exemption apply only to transactions involving eligible participants.\(^{229}\) As a proxy for suitability, eligible participants included certain business entities, ERISA benefit plans, and natural persons meeting an explicitly defined financial suitability threshold, certain financial institutions, governmental entities, certain broker-dealers subject to the Exchange Act of 1934, and certain commodity merchants, brokers, and traders.\(^{230}\) Some commentators criticized the suitability proxy as too restrictive in that a number of willing swap market participants did not qualify under the suitability requirement.\(^{231}\)

Finally, revised Part 35 limited safe harbor to interest rate swaps cleared through authorized clearing organizations.\(^{232}\) The Commission defined clearing organizations as organizations that act as a "universal counterparty" to provide "a credit enhancement function . . . in connection with netting and/or settling of the payments and payment obligations" of swap participants.\(^{233}\) Such an organization would have been authorized when 1) recognized by the Commission as an authorized clearing organization, 2) subject to SEC regulation, 3) subject to the jurisdiction of the Federal Reserve or the Comptroller of the Currency or 4) subject to similar oversight in a foreign jurisdiction, if it also "abide[d] by appropriate and adequate information-sharing arrangements."\(^{234}\)
2. Revised Part 35 Did Not Exempt Swap Transactions from the Anti-Deception Provisions of the Act. Like the old Part 35 regime, revised Part 35 would not have shielded interest rate swaps from the anti-deception provisions of the Act. Accordingly, the Commission would have had authority to police transactions that fell under the Act’s jurisdiction for deceptive behavior, notwithstanding the administrative exemption. Consider the now-infamous swap deals between Gibson Greetings and Bankers Trust (“BT”). In 1994, Gibson sued BT after suffering a $23 million loss in a series of exotic interest rate swap transactions. The swaps were exotic in that the swap cash flows “varied according to a complex formula that made them hypersensitive to rising rates.” Gibson alleged that BT’s agents deliberately misrepresented the nature of the swap cash flows. The allegation triggered investigations by the SEC, the Federal Reserve, and the Commission.

The Commission based its action on the theory that BT acted as Gibson’s advisor for the transaction. According to the Commission, BT’s advisory position rendered it a “commodity trading advisor” under the Act. Hence, the Commission argued that it had the authority to police BT’s allegedly fraudulent misrepresentations. The Act defines “commodity trading advisor” as anyone who, “for compensation or profit, engages in the business of advising others... to... the advisability of trading in any con-
tract of sale of a commodity . . . subject to the rules of a contract market." Thus, the enforcement action necessarily implied that the Act's jurisdiction extends to at least one of the swap transactions between Gibson and BT. When critics charged that the Commission did not have jurisdiction over the transactions in question, the Commission deftly begged the question.

3. The Commission Had Discretion to Revise or Repeal the Safe Harbor. The final, and perhaps the most important basis, for legal risk under the revised Part 35 regulatory framework was that the framework existed at the discretion of the Commission. At some point, the Commission might have exercised its discretion to fashion a more interventionist regulatory framework. In 1998, the Commission, under the leadership of Broksee Born, a proponent of aggressive regulation of the OTC derivative markets, announced a reexamination of the Commission's hands-off regulatory approach vis-à-vis OTC derivative markets. Many observers interpreted the Commission's 1998 "concept release" as a tacit projection of Commission regulatory authority over the OTC derivative markets and vehemently protested. Treasury Secretary Robert Rubin, Federal Reserve Chair-

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243 Id. § 1a(3)(A)(i)(1) (emphasis added); see FDIC v. Hildenbrand, 892 F. Supp. 1317, 1324-25 (D. Colo. 1995) (interpreting commodity trading advisor as a person "in the business of advising others on the value or advisability of trading in the purchase or sale of futures contracts or options").

244 See Harris, supra note 80, at 1144-45; see also John C. Coffee Jr., Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation, 50 BUS. LAW. 447, 448 (1995) ("Although the CFTC's opinion was diplomatically vague on this score, its conclusion that BT was a 'commodities trading advisor' implied that swaps were sometimes either futures contracts or commodities options. Even if thinly veiled, this analysis meant the CFTC was contending that it had jurisdiction . . . .").

245 See Tim W. Ferguson, Business World: Commodities Boss Forswears Future in Swaps, WALL ST. J., Jan. 3, 1995, at A9. Ferguson argues that the enforcement action amounted to an illegitimate power grab since the Act's jurisdiction did not extend to interest rate swaps. In response, Commission Chairwoman Mary Shapiro begged the essential question: "You were fed a bill of goods. We did not say that swaps are futures . . . or use a statutory provision that says that swaps are futures." Id. Rather, the Commission based its jurisdiction on "taped evidence indicating intent to deceive a client." Id.

246 See, e.g., Rob Garver, Capital Briefs: Swaps Measure Delayed as Agencies Argue, AM. BANKER, May 12, 2000, at 2 (reporting that "[b]ankers and others who engage in swaps trading are concerned that future CFTC chairmen could require that these products be traded on a public exchange overseen by the federal government").

247 Over-the-Counter Derivatives, 63 Fed. Reg. 26,114, 26,115 (1998) (to be codified at 17 C.F.R. pts. 34, 35) ("The Commission has been engaged in a comprehensive regulatory reform effort designed to update the agency's oversight of both on exchange and off-exchange markets. As part of this process, the Commission believes that it is appropriate to reexamine its regulatory approach to the OTC derivatives market . . . .").

248 See Concept Release Concerning Over-the-Counter Derivatives, 64 Fed. Reg. 65,669 (1999) (to be codified at 17 C.F.R. pts. 34, 35) ("The [concept release] has been widely perceived, both within the derivatives industry and among other financial regulators, as indicating an intent to expand the Commission's regulatory reach with respect to OTC derivatives."). The reaction was not overblown. Chairwoman Born believed her efforts to extend the Commission's regulatory reach to the OTC derivative markets to be a matter of "principle."
man Alan Greenspan, and SEC Chairman Arthur Levitt challenged the Commission’s zeal on both legal and policy grounds.\textsuperscript{249} Chairman Greenspan went so far as to assert that Commission regulation of any financial derivative transaction between sophisticated actors serves no legitimate purpose and is socially inefficient.\textsuperscript{250} Despite Chairwoman Born’s tenacious defense of the Commission’s position,\textsuperscript{251} opponents eventually forced the agency into submission, and its concept release was formally withdrawn.\textsuperscript{252}

The Commission’s pro-market stance after the 1998 concept release debacle was a consequence of a high-stakes political scrum between the Commission and an array of opponents that included other financial regulators and market participants. Before enactment of the statutory exemption, the specter of aggressive Commission regulation might have again arisen from its tomb. Though unlikely under the Bush administration, interventionist zeal might again take hold of the public policy conscience. In such a climate,\textsuperscript{253} the Com-

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\textsuperscript{250} See \textit{Over-the-Counter Derivatives: Hearing before the Comm. on Agriculture, Nutrition and Forestry of the U.S. Senate, 105th Cong. 50 (1998) (statement of Alan Greenspan, Chairman, Board of Governors, Federal Reserve System). After arguing that the Act exists merely to prevent manipulation of commodity prices, Chairman Greenspan concluded:

\begin{quote}
[The Federal Reserve Board] questions whether the [Act] as currently implemented is an appropriate framework for professional trading of financial futures on exchanges. The key elements of the [Act] were put into place in the 1920’s and 1930’s to regulate the trading of agricultural futures by the general public. The vast majority of financial futures traded simply are not as susceptible to manipulation as agricultural and other commodity futures where supplies are more limited . . . [and] simply do not require the consumer protections that may be needed by the general public. Regulation that serves no useful purpose hinders the efficiency of markets to enlarge standards of living.
\end{quote}

\textit{Id.}\textsuperscript{251} See Michael Schroeder, \textit{Commodities: CFTC Chairwoman Won’t Halt Study of OTC Derivatives Rules, WALL ST. J., June 11, 1998, at C1.} ("[Chairwoman Born] told Congress . . . that she has no intention of halting a study to consider new regulations for the multitrillion-dollar over-the-counter derivatives market. In dismissing widespread criticism, Ms. Born bluntly testified that complaints ‘reflect[ed] a lack of understanding . . . and a desire to avoid government oversight.’") (third alteration in original).
\textsuperscript{253} One of the lessons the New Deal teaches is that the proponent of regulation loves financial malaise because nothing causes the political winds to shift in his favor more than such distress. The near collapse of Long Term Capital Management ("LTCM"), which had an extremely large and heavily leveraged exposure to various derivatives, posed enough of a threat to the financial system to motivate the Federal Reserve to engineer a bailout financed by leading U.S. financial institutions. The event re-energized Chairwoman Born’s flagging campaign to establish a regulatory beachhead in OTC derivative markets. She took the event as a vindication of her position and circulated a pamphlet among key congressional leaders warning that the situation underscored the need for an aggressive Commission presence in those markets. \textit{See Schroeder, supra note 251, at A1. Ultimately, however, influential members of Congress came to blame the collapse of LTCM on lax lending practices rather than on inadequate regulation.}
mission, with an aggressive interventionist at the helm, might have lifted the discretionary swap exemption, possibly exposing the OTC swap market to the ravages of the exchange-trading requirement.

III. STATUTORY SOLUTION TO JURISDICTIONAL AMBIGUITY: THE MODERNIZATION ACT

A. The Modernization Act's Exemptions

Ultimately, the attempt to mitigate legal risks for swap participants through regulatory means proved unsuccessful. In late 1999, the President’s Commission on Financial Markets recommended that Congress statutorily exempt most derivative transactions from the Act’s jurisdiction. About a year later, Congress enacted the recommendation. The Modernization Act exempts “agreement[s], contract[s] or transaction[s]” in “excluded commodit[ies]” between “eligible contract participants” not executed on trading facilities from most provisions of the Act, including the anti-deception provisions. “Excluded commodity” essentially means any stochastic variable associated with a non-finite process that has a financial, commercial, or economic consequence. “Eligible contract participants” functions as a suitability proxy intended to limit the exception to transactions involving sophisticated parties. For such transactions executed on electronic trading facilities, the Modernization Act limits exemption to negotiated transactions for the account of the transactors, as distinguished from the exchange-enforced standardized futures. Electronic trading facilities should not be confused with the exempt futures exchanges provided for in the Modernization Act. While the Modernization Act shields exempt futures markets from most provisions of the Act, it explicitly exposes transactions executed through exempt futures exchanges to the anti-deception provisions of the Act. Exempt principal-to-principal derivative transactions executed on trading facilities do not present such exposure.
Most interest rate swaps, whether or not executed through trading facilities, fit neatly within the derivatives exemption. Interest rates explicitly qualify as an excluded commodity. Moreover, the credit intensive nature of interest rate swaps limits their use, for the most part, to firms that meet the qualifications for eligible contract participants. Finally, interest rate swaps are negotiated transactions that meet the “principal-to-principal” condition of the exemption for derivative transactions effected through a trading facility. In addition to the derivatives exception, the Modernization Act contains a separate exclusion for swap transactions. The swap exclusion applies to any negotiated “agreement, contract or transaction” between “eligible contract participants” that is not executed on a trading facility and does not involve an agricultural commodity. While the swap exclusion is surplusage for swaps on excluded commodities such as interest rates, it provides the cover for qualifying swap deals involving non-agricultural, non-excluded commodities such as oil or metals.

B. Lingering Legal Risk

While the exemption is sweeping, it is not an absolute shield from legal risk for interest rate swap participants. The Modernization Act exempts qualifying derivative transactions from the exchange-trading requirement and the anti-deception provisions of the Act. Moreover, no derivative participant may sue to rescind a derivative agreement between “eligible contract participants or persons reasonably believed to be eligible contract participants.” However, the suitability limitation presents legal risk for persons, natural or otherwise, ready and able to participate in swap transactions who fail to qualify as an “eligible contract participant.” The requirement is an imperfect proxy for suitability that will leave suitable transactions exposed to the Act’s jurisdiction. Congress tried to provide for this problem by granting the Commission authority to extend the scope of “eligible contract participant” to “any other person that the Commission determines to be eligible in light of the financial or other qualifications of the person.” However, a number of organizations complained about the restrictive nature of a similar suitability approach adopted by the Commission as part of the Part 35 revision but which was aborted with enactment of the Modernization Act.

262 See id. § 101.
263 See id.
264 See id. § 103.
265 See supra Part II.A.1.
266 Commodity Futures Modernization Act § 120.
267 Id. § 101.
268 See A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations; Rules Relating to Intermediaries of Commodity
An interesting question involves the status of interest rate swap transactions between non-eligible yet financially suitable persons. Would such transactions fall within the Act’s jurisdiction? Ultimately, this question turns on the contract for future delivery analytics. However, the enactment of the Modernization Act adds new twists to the analysis that might make it difficult for regulators and courts to conclude that interest rate swaps involving ineligible participants nevertheless fall beyond the Act’s jurisdiction on the basis that such transactions do not constitute contracts for future delivery.

At the suggestion of the President’s Commission Report, Congress explicitly limited the derivative transactions exemption to deals in exempt commodities between eligible participants. Moreover, the Modernization Act, in its definition of eligible participants, gives the Commission plenary authority to expand the scope of the term. Thus, one might conclude that Congress intended the Act’s jurisdiction to reach similar transactions between ineligible participants. This conclusion is buttressed by the fact that the Modernization Act charges the four federal financial regulators to “conduct a study of issues involving the offering of swap agreements to persons other than eligible contract participants” for the purpose of, among other things, recommending an “appropriate regulatory structure to address consumer protection.” The regulatory flexibility as to the definition of eligible contract participants and the charge to study the effects of expanding the scope of the exemption probably means that Congress intended otherwise exempt transactions involving non-qualified persons to be covered by the Act. However, the Modernization Act says nothing that would clarify the meaning of “contract for future delivery.” In fact, the Modernization Act explicitly precludes a presumption that contracts not qualifying for the Modernization Act’s exemption fall under the Act’s jurisdiction. Nevertheless, while Judge Easterbrook provides a sound basis for interpreting “contract for future delivery” to exclude negotiated interest rate swaps from the Act’s jurisdiction, a counselor would live dangerously by relying on such a theory as a basis for advising a non-qualified client to participate in the OTC swap market.

As for exempt interest rate swap transactions, the Modernization Act explicitly leaves such transactions exposed to all state laws except state or local anti-gambling or anti-bucket shop laws. While a rigorous analysis of state-based legal risk for swap transactions is be-

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269 See supra Part II.
270 § 105.
271 See id. § 107.
272 See supra Part II.A.3.
273 See §§ 12(d), 16(d), 103, 117.
Beyond the scope of this Comment, the following anecdote demonstrates that such risk is not trivial. Consider the case of the 5/30-interest rate swap between Bankers Trust and Procter & Gamble discussed above. After losing over $100 million on the 5/30-interest rate swap, P&G sued to avoid its losses. P&G claimed, essentially, that BT had misled it about the interest rate risk presented by the convoluted swap payoff formula. The following statement by Edwin Artzt, CEO of P&G, captured the crux of P&G's theory supporting rescission: "There is a notion that end users of derivatives must be held accountable for what they buy. We agree completely, but only if the terms and risks are fully and accurately disclosed." P&G buttressed its position by suggesting fraud, maintaining that BT representatives, responding to P&G's requests for a sensitivity analysis of the swap payouts under various interest rate circumstances, said that "possible changes in rates or volatilities would not have a significant effect on P&G's position... and that it was not worth providing to P&G any new sensitivity analysis." BT retorted that P&G's loss "was the result of market risks that the company knowingly took through a transaction that it understood and fully approved," noting that a senior P&G official approved the deal. BT chairman Charles Sanford announced at BT's annual meeting that the bank had no ethical obligation to P&G and expressed confidence about BT's prospects in litigation. P&G sought a declaratory judgement in federal court that it owed BT nothing under the swap. Moreover, P&G sought punitive damages, attorney fees, and other costs.

Mr. Sanford's confidence was almost vindicated. A federal court rejected most of P&G's claims, including all federal claims. However, the court sent a couple of state-law issues to trial. The court concluded that BT had a duty under New York law to disclose to P&G material information "both before the parties entered into the swap transactions and... during their performance." Moreover, the court concluded that BT had a duty under New York law "to deal fairly and in good faith during the performance of the swap transactions." Hours after the court's pretrial ruling, BT agreed to forgive most of P&G's loss. P&G was allowed to get away with about $20 million in losses. Clearly, BT's state-law exposure proved decisive. The Modernization Act does nothing to mitigate such exposure.

274 See supra Part IB.1.
275 Thomas, supra note 218, at A6.
276 Id.
277 Id.
279 Id. at 1291.
280 Id.
CONCLUSION

Judge Easterbrook provides a solid basis for the proposition that OTC interest rate swaps fall beyond the Act’s main jurisdictional boundary. OTC interest rate swaps would fall beyond the Act’s jurisdiction if “contract for future delivery” were interpreted with reference to the institutional differences between forward and futures transactions. Enactment of the Modernization Act was critical, however, because it is not clear that either the CFTC or the courts would have ultimately favored such an approach in dealing with transactions involving financial “commodities.” Quite possibly, some variant of the traditional model would have been applied. Under the traditional model, the Act’s jurisdictional fog, like an angel of death, would have enveloped the OTC derivative markets, suffocating all who would make use of them. Market participants, sensing that the Act’s jurisdictional ambiguity might be resolved against them, became increasingly skittish in recent years. The Modernization Act, by clearly excluding OTC interest rate swaps involving eligible participants from the Act’s jurisdiction, should allay such fears.

LOUIS V ITALE

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