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COMMODITY FUTURES TRADING COMMISSION (**CFTC**)

Exemption for Certain Contracts Involving Energy Products

58 FR 21286

DATE: Tuesday, **April** 20, 1993

ACTION: Final order.

[*21286]

SUMMARY: In response to an application for exemptive relief, the Commodity Futures Trading Commission ("Commission") proposed to issue an order exempting from regulation under the Commodity Exchange Act, 7 U.S.C. 1 *et seq.* ("Act"), certain contracts for the deferred purchase or sale of certain specified **energy** products. 58 FR 6250 (January 27, 1993). This exemptive order is being issued pursuant to the exemptive authority recently granted to the Commission in the Futures Trading Practices Act of 1992. The Commission's Order is intended to provide greater legal certainty regarding trading in these products.

EFFECTIVE DATE: May 20, 1993.

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SUPPLEMENTARY INFORMATION:

I. Background

A. Statutory Framework

As the Commission noted in the Notice Proposing Issuance of an Order, 58 FR at 6250, section 2(a)(1)(A) of the Act grants the Commission exclusive jurisdiction over accounts, agreements and transactions commonly known as options, and transactions involving contracts of sale of a commodity for future delivery traded or

executed on a contract market or any other board of trade, exchange, or market. 7 U.S.C. 2. The Act and Commission rules require that transactions in commodity futures contracts and commodity option contracts, with narrowly defined exceptions, occur on or subject to the rules of contract markets designated by the Commission. n1

n1 Sections 4(a), 4c(b) and 4c(c) of the Act; 7 U.S.C. 6(a), 6c(b), 6c(c). Section 4(a) of the CEA specifically provides, *inter alia,* that it is unlawful to enter into a commodity futures contract that is not made on or subject to the rules of a board of trade which has been designated by the Commission as a "contract market" for such commodity. 7 U.S.C. 6(a). This prohibition does not apply to futures contracts made on or subject to the rules of a foreign board of trade, exchange or market. 7 U.S.C. 6(a).

The recently enacted Futures Trading Practices Act of 1992, Public Law No. 102-564 ("1992 Act"), added new subsections (c) and (d) to section 4 of the Act. New section 4(c)(1) authorizes the Commission, by rule, regulation, or order, to exempt any agreement, contract or transaction, or class thereof, from the exchange-trading requirements of section 4(a) or any other requirement of the Act other than section 2(a)(1)(B). n2 New section 4(c)(2) provides that the Commission may not grant an exemption from the exchange-trading requirement of the Act unless, *inter alia,* the agreement, contract or transaction will be entered into solely between "appropriate persons", a term defined in new section 4(c)(3). n3 In granting exemptions, the Commission must also determine specifically that the exchange trading requirements of section 4(a) should not be applied, that the agreement, contract or transaction in question will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the Act and that the exemption would be consistent with the public interest and the purposes of the Act. n4

n2 Specifically, section 4(c)(1), 7 U.S.C. 6(c)(1), provides:
"In order to promote responsible economic or financial innovation and fair competition, the Commission by rule, regulation, or order, after notice and opportunity for hearing, may (on its own initiative or on application of any person, including any board of trade designated as a contract market for transactions for future delivery in any commodity under section 5 of this Act) exempt any agreement, contract, or transaction (or class thereof) that is otherwise subject to subsection (a) (including any person or class of persons offering, entering into, rendering advice or rendering other services with respect to, the agreement, contract, or transaction), either unconditionally or on stated terms or conditions or for stated periods and either retroactively or prospectively, or both, from any of the requirements of subsection (a), or from any other provision of this Act (except section 2(a)(1)(B)), if the Commission determines that the exemption would be consistent with the public interest."

n3 Section 4(c), 7 U.S.C. 6(c)(3), provides that:
"* * *the term "appropriate person" shall be limited to the following persons or classes thereof:
"(A) A bank or trust company (acting in an individual or fiduciary capacity).
"(B) A savings association.
"(C) An insurance company.
"(D) An investment company subject to regulation under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.).
"(E) A commodity pool formed or operated by a person subject to regulation under this Act.
"(F) A corporation, partnership, proprietorship, organization, trust, or other business entity with a net worth exceeding $ 1,000,000 or total assets exceeding $ 5,000,000, or the obligations of which under the agreement, contract or transaction are guaranteed or otherwise supported by a letter of credit or keepwell support, or other agreement by any such entity or by an entity referred to in subparagraph (A), (B), (C), (H), (I), or (K) of this paragraph.
"(G) An employee benefit plan with assets exceeding $ 1,000,000 or whose investment decisions are made by a bank, trust company, insurance company, investment adviser registered under the Investment Advisers Act of 1940 (15 U.S.C. 80a-1 et seq.), or a commodity trading advisor subject to regulation under this Act.
"(H) Any governmental entity (including the United States, any state, or any foreign government) or political subdivision thereof, or any multinational or supranational entity or any instrumentality, agency, or department of any of the foregoing.
"(I) A broker-dealer subject to regulation under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.)

acting on its own behalf or on behalf of another appropriate person.
"(J) A futures commission merchant, floor broker, or floor trader subject to regulation under this Act acting on its own behalf or on behalf of another appropriate person."

n4 Specifically, section 4(c)(2), 7 U.S.C. 6(c)(2), states:
"The Commission shall not grant any exemption * * * from any of the requirements of subsection (a) unless the Commission determines that (A) the requirement should not be applied to the agreement, contract, or transaction for which the exemption is sought and that the exemption would be consistent with the public interest and the purposes of this Act; and (B) the agreement, contract, or transaction --
"(i) Will be entered into solely between appropriate persons; and
"(ii) Will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under this Act."
As is frequently the case when Congress grants a regulatory agency authority to act in a manner consistent with "the public interest and the purposes of" its enabling statute, little statutory elaboration is given. As commonly understood, however, an agency, such as the Commission, is to apply this standard against the template of its regulatory scheme. In this regard, the Conference Report states that the "public interest" under section 4(c) includes "the national public interests noted in the [Act], the prevention of fraud and the preservation of the financial integrity of markets, as well as the promotion of responsible economic or financial innovation and fair competition." H.R. Rep. No. 978, 102d Cong., 2d Sess. 78. The Conference Report goes on to state that "[t]he Conferees intend for this reference to the "purposes of the Act" to underscore their expectation that the Commission will assess the impact of a proposed exemption on the maintenance of the integrity and soundness of markets and market participants." H.R. Rep. No. 978, 102d Cong., 2d Sess. 78. However, the Conference Report on the 1992 Act also states that:
"The Conferees do not intend for this provision to allow an exchange or any other existing market to oppose the exemption of a new product solely on grounds that it may compete with or draw market share away from the existing market." -- H.R. Rep. No. 978, 102d Cong., 2d Sess. 79 (1992).

B. The Proposed Order

The Commission, on January 27, 1993, published for public comment the proposed order. The Commission proposed this order in response to an application for exemptive relief ("application") filed by a group of entities (the "**Energy** Group") which represented that each is a producer, processor and/or merchandiser of crude oil, natural gas and/or other crude oil or natural gas product, or is otherwise engaged in a commercial business in these commodities. n5

n5 The submission represents that each of the members of the **Energy** Group is an active participant in the principal domestic and international markets for crude oil and/or natural gas and the products and by-products thereof, which regularly engages in the purchase of such commodities for use in its business operations, the sale of such commodities for use by end-users and the transport of such commodities through pipeline, vessel or truck deliveries.

The application, submitted pursuant to Section 4(c) of the Act, is for an order exempting from regulation transactions for the purchase and sale of certain **energy** products through contracts that meet specified criteria. As noted in the Notice Proposing Issuance of an Order, the applicants based their request for an exemption both on the nature of the participants in, and on various representations regarding the usage and form of, these transactions. n6

n6 Specifically, as stated in the application, see 58 FR at 6251, the exemption would:
"* * * preclude participation * * * by members of the general public and * * * limit the * * * [relief] to those appropriate persons who, in the context of their business activities, incur risks related to the underlying physical commodities. In addition, the exemption will require that each * * * Contract [covered by the relief would] impose binding delivery obligations on the parties (with the exception of those covered by * * * [a specified] proviso * * *) and that it not provide either party with the unilateral right to require its counterparty to offset the contract by cash settlement. The Contracts will therefore expose the parties to substantial economic risk of a commercial nature. Further, the Contracts will be entered into between two parties each of which acts as principal, and the material economic terms, including credit terms of the

transaction will be subject to individual negotiation between the parties."

The application further explained that the requested exemption:

"* * * focuses on the commercial nature of the parties and the fact that the * * * Contracts impose binding delivery obligations, thereby establishing a "bright line" test. The exemption recognizes that, regardless of the purposes for which the parties enter into a * * * Contract, they may be required by their counterparty to make or receive delivery pursuant to the terms of the Contract. This will permit commercial entities to enter into * * * Contracts for hedging, risk management, pricing or other commercial purposes, provided that the terms of the agreements impose binding delivery obligations, the parties are legally permitted to make and receive delivery and are capable of doing so. In this respect as well, the exemption will facilitate the use of * * * Contracts for legitimate and necessary business purposes." (Citations omitted.) [*21288]

The applicants further reasoned that the exemption was needed to provide legal clarity and certainty regarding the trading of these products. In this regard, as noted in the **Federal Register** notice, 58 FR at 6251, the applicants contended that the requested exemption should "recognize() the ability of commercial entities to settle * * * Contracts through the full range of commercially available forms of settlement," and should "allow commercial entities to conduct their necessary business activities in the domestic and foreign oil and gas markets * * * with the requisite degree of legal certainty and comfort."

In addition, the application also addressed the public interest to be served by the Commission's issuance of an order granting this request for an exemption. The Commission included this analysis in the Notice for comment, quoting extensively from it. See, 58 FR at 6251. In this regard, as noted in the **Federal Register** notice, the applicant reasoned that the exemption would be in the public interest because "[t]hose entities which satisfy * * * the proposed exemption are sufficiently sophisticated and knowledgeable to protect their own interest in connection with * * * Contracts, regardless of whether the regulatory protections afforded under the Act are available * * *;" because "the exemptive relief * * * is necessary in order to permit commercial commodity markets to function effectively * * *;" because "the financial integrity of the markets for such * * * Contracts will be adequately addressed by the limitation of appropriate persons and the measures adopted by each market participant * * *;" and because "such Contracts lack the degree of standardization and fungibility required in order to permit them to be traded on an exchange." *Id.*

Finally, the Commission included seven issues on which it particularly sought public comment. These included the list of eligible "appropriate persons," the Commission's description of the commodities covered by the exemption, its description of the cash market, including the use of brokers and of netting arrangements, the possible effect on contract markets from granting the exemption, and whether section 4b of the Act should be applicable to these transactions.

C. Comments Received

The comment period closed on February 26, 1993. Sixteen comments were received; including eight from active participants in the **energy** cash or forward markets or entities representing such participants, three from futures exchanges, three from futures industry associations, one from a bar association committee and one from an attorney. All but one of the commenters generally supported issuance by the Commission of the proposed order.

Most commenters confirmed the accuracy of the Commission's description of applicable of applicable cash market practices. Several, however, suggested changes to the Commission's description, including in particular, clarifications with regard to the degree of standardization, or individual negotiation, of these contracts. Several further recommended that the Commission clarify additional aspects of the proposed order, including in particular, the applicability of the order to various other types of instruments and other of the Commission's rules and interpretations.

Others recommended that the commission modify certain aspects of the proposed order. These recommendations included modifying the persons proposed to be eligible for this relief, the breadth of commodities covered under the proposed order, and the effective date of the exemption. The opposing commenter, the Chicago Board of Trade ("CBT"), questioned the Commission's statutory authority for issuing the order as proposed, the rationality and fairness of the proposed order and whether the Commission has provided a meaningful opportunity for comment on the statutorily-required determinations regarding the public interest which it must make in issuing this order.

II. The Final Order

Based upon its careful consideration of the application for exemption, the comments received, and its

independent analysis, the Commission is issuing an order under its authority in section 4(c) of the Act to exempt specified transactions from Commission regulation. The final order, and in particular, the modifications made to it from the proposal, are discussed below.

A. Statutory and Regulatory Basis of the Order

In proposing to issue this order under section 4(c) of the Act, the Commission made clear that it did "not intend to determine whether **Energy** Contracts are subject to the Act," nor to "affect the applicability to **Energy** Contracts of exemptions or interpretations previously issued by the Commission or its staff, including the Statutory Interpretation Concerning Forward Transactions, * * * or the forward contract exclusion set forth in section 2(a)(1) of the Act * * *." 58 FR at 6253, n.18. The CBT, the sole commenter opposing issuance of the proposed order, maintained that issuance of this order, pursuant to section 4(c) of the Act, was inconsistent with prior actions of the Commission and with the CBT's reading of the scope of the Act's section 4(c) exemptive authority.

The Congress, however, did not intend such a restrictive reading of the Commission's 4(c) exemptive authority. On the contrary, the Conferees stated that:

"In granting exemptive authority to the Commission under new section 4(c), the Conferees recognize the need to create legal certainty for a number of existing categories of instruments which trade today outside of the forum of a designated contract market.

"The provision included in the Conference substitute is designed to give the Commission broad flexibility in addressing these products * * *.

"In this respect, the Conferees expect and strongly encourage the Commission to use its new exemptive power promptly upon enactment of this legislation in four areas where significant concerns of legal uncertainty have arisen: (1) hybrids, (2) swaps, (3) forwards, and (4) bank deposits and accounts."

H.R. Rep. No. 978, 102d Cong., 2d Sess. (1992) at 80-81.

The Conferees further stated that they did

"not intend that the exercise of exemptive authority by the Commission would require any determination before hand that the agreement, instrument, or transaction for which an exemption is sought is subject to the Act. Rather, this provision provides flexibility for the Commission to provide legal certainty to novel instruments where [*21289] the determination as to jurisdiction is not straightforward. Rather than making a finding as to whether a product is or is not a futures contract, the Commission in appropriate cases may proceed directly to issuing an exemption."

H.R. Rep. No. 978, 102d Cong. 2d Sess., (1992) at 82-83. n7

n7 In any event, the commenter maintains that "CEA § 4(c) compels the **CFTC,** at the least, to determine that every instrument it exempts could be a futures contract." In this regard, the Commission notes that the legal uncertainty which this exemptive order addresses was occasioned by the belief of some observers that some of the instruments at issue are indeed futures contracts. See, e.g., *Transnor (Bermuda)* v. *BP North America Petroleum,* 738 F. Supp. 1472 (S.D.N.Y. 1990). Thus, regardless of the Commission's position on the appropriate characterization for specific types of transactions, the status of some of these transactions under the Act appears likely to be subject to continued dispute, and this potential for uncertainty provides a sufficient basis for the exercise of exemptive authority as to these transactions.

Separately, several commenters recommended modifications to the proposed order on the grounds that relief under the order was not as far-reaching as the relief recently granted by the Commission with regard to hybrid instruments or to swap agreements. Thus, one commenter argued that the Commission should make this exemption applicable to any cash-settled **energy** contract because such transactions arguably would be exempt from regulation under the Commission's Exemption for Certain Swap Agreements. See, 58 FR 5587 (January 22, 1993). A second commenter suggested that the Commission reiterate that this relief was not intended to vitiate the continued vitality of the Commission's Statutory Interpretation Concerning Forward Contracts, 55 FR 39188 (Sept. 25, 1990). Finally, a third commenter requested that the Commission clarify that this exemptive order was not intended to supersede any other Commission rule or interpretation

regarding those transactions which have been characterized as forward or trade option transactions.

In proposing this order, the Commission made clear that it did not intend to supersede or vitiate any other of its rules or interpretations, in particular those relating to the section 2(a)(1) exclusion of the Act. 58 FR 6253, n. 18. Rather, this order was proposed in response to a particular application for relief, and was intended to provide legal clarity with regard to certain transactions as described therein in specified commodities. Thus, the Commission is limiting the order to existing practices in these markets, as represented in the application. Nor does the Commission believe that the order should go beyond the representations in the application with regard to practices in these markets to practices which may be permitted under other Commission rules, such as the exemption for swaps in part 35 of its rules. Finally, by confining its order to these transactions, the Commission is not thereby making a determination regarding, or otherwise determining the legality or status of, any other type of transaction or superseding any other rule or interpretation. n8

n8 In this regard, the Commission reiterates that the exemption granted here does not affect the applicability to **Energy** Contracts of the Commission's Statutory Interpretation Concerning Forward Transactions, 55 FR 39188 (September 25, 1990). Any transaction that has been or will be entered into consistent with that Interpretation remains excluded from regulation under the Act.

B. Commodities Eligible for the Exemption

Several commenters suggested that the Commission not limit this order for exemption to **Energy** Contracts, but rather extend it to all commodities. One commenter suggested that an exemption limited to **energy** contracts increases uncertainty regarding forward contract markets in other commodities, thus requiring that the Commission expand this exemption to cover transactions in all commodities. A second commenter argued that there was no legal basis to distinguish **energy** products from other commodities.

As discussed above, however, the Commission, in proposing this exemptive order, was responding to a particular application for relief. The record before the Commission, and the representations in the application, are limited to trading practices in the markets relating to **energy** products. See, 58 FR 6251, n.8. Moreover, the Congress specifically directed the Commission to consider the appropriateness of exemptive relief for the crude oil market. H.R. Rep. No. 978, 102d Cong., 2d Sess. at 81-82 (1992).

Based upon the intent of the Congress in enacting this exemptive authority, and upon the limited focus of the application for exemption and the corresponding record, the Commission is of the view that this final order is appropriately limited to transactions in **Energy** Contracts. Of course, as the Commission noted previously, this exemption in general, and its limitation to **Energy** Contracts in particular, does not affect the applicability or vitality of existing Commission policies or interpretations regarding transactions in these, or any other, commodities.

Several commenters also requested that the Commission make technical amendments to its enumeration of commodities included within the meaning of the term "**Energy** Contract." The Commission defined this term in its Notice Proposing Issuance of an Order as, "contracts for the purchase and sale of crude oil, natural gas, natural gas liquids or other **energy** products, including products derived from crude oil, natural gas or natural gas liquids, and used primarily as an **energy** source * * *." 58 FR 6251.

In particular, one commenter recommended that "condensates" should be explicitly included within the commodities enumerated. The Commission agrees. Other comments reflected confusion over whether a product must actually be used as an **energy** source in order to be included within the exemption. The Commission did not intend that inclusion of a particular product within the exemption rest upon a subjective test of intent as to its use as an **energy** source. For example, a particular company may purchase cargoes of crude oil for use in various commercial activities. The Commission did not mean to exempt only transactions for those specific shipments of the specified products which are used as an **energy** source. Rather, the enumerated products -- crude oil, condensates, natural gas and natural gas liquids, which can be used in their natural state for **energy** -- are included within the exemption regardless of whether the actual or ultimate use of these commodities is as an **energy** source.

Derivatives of these products are included to the extent that the derivative product is used primarily as an **energy** source. Again, however, it is the derivative product itself, such as gasoline, heating oil, or diesel fuel, and not the use made of particular lots of a fungible product, which is included under the exemption. The Commission, therefore, in its final order, is clarifying the description of the commodities included in the

exemption.

C. Entities Eligible for the Exemption

The Commission, in its Notice, specifically requested comment regarding its enumeration of the entities which would be eligible for exemptive relief. This request elicited diverse opinions which raised several issues. As proposed, the exemptive order would have been applicable to "commercial participants who, in connection with their business activities, incur risks related to the underlying physical commodities, have the capacity to make or take delivery under the terms of the contracts, and are also eligible "appropriate persons." The [*21290] Commission further defined "eligible appropriate persons" as:

"(1) A bank or trust company (acting in an individual or fiduciary capacity) which is legally permitted and otherwise authorized to engage in such transactions; (2) a corporation, partnership, proprietorship, organization, trust, or other business entity with a net worth exceeding $ 1,000,000 or total assets exceeding $ 5,000,000, or the obligations of which under the agreement, contract or transaction are guaranteed or otherwise supported by a letter of credit or keepwell support, or other agreement by any such entity or by an entity referred to in subsections (H), (I) or (J) of Section 4(c)(3); (3) any governmental entity (including the United States, any state, or any foreign government) or political subdivision thereof, or any multinational or supranational entity or any instrumentality, agency, or department of any of the foregoing; (4) a broker-dealer subject to regulation under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) acting on its own behalf or on behalf of another appropriate person (as set forth herein); and (5) a futures commission merchant subject to regulation under the Act acting on its own behalf or on behalf of another appropriate person (as set forth herein)."

58 FR 6252.

Several commenters opined that the entities eligible for this relief should be extended to include not only "commercial participants * * * who incur risks related to the underlying physical commodities, [and] have the capacity to make or take delivery * * *." but also to include any appropriate person which is legally authorized to make or take delivery of the physical commodity. These commenters further suggested that an entity could so qualify "by contracting out its obligations to a person or entity that provides such services as storage or transportation of the underlying commodity."

In addition to the above revision to eligibility, several commenters also supported the inclusion of commodity pools within the list of "eligible appropriate person." These commenters supported this revision by reasoning that, "because there is no basis to distinguish between them [commodity pools] for purposes of exemptive relief under section 4(c)," commodity pools should be included within the terms of this exemption "on the same terms as swap transactions."

Other commenters disagreed with this view. One such commenter, a futures exchange, contended that permitting commodity pools to be covered by the exemption was contrary to the proposed order's stated rationale, reasoning that:

"[t]he purpose of the Proposed Order is ostensibly to permit transactions which are entered into for legitimate commercial purposes * * *. To treat a speculative commodity pool * * * as the equivalent of an entity engaged in the business of being a producer, processor and/or merchandiser of **energy** products, is contrary to the Proposed Order's objective of facilitating commercial activities free of unnecessary regulatory burdens * * *."

Based upon the above reasoning emphasizing the commercial nature of the eligible entities, the commenter further recommended that the Commission state explicitly that eligible parties under the exemption must have, "as part of the routine course of their business activities, * * * the physical capacity to produce, refine, store, transport or otherwise tangibly control the commodity," and questioned the need for conditions related to net worth and total assets. The commenter noted that by limiting the exemption to commercials, it would apply only to sophisticated entities and that the net worth and total asset conditions were therefore unnecessary, potentially excluding unnecessarily "small or start-up commercial entities * * *."

After carefully considering the views of the commenters, the Commission is limiting the final order to those types of commercial participants identified in the proposed order. The Commission is persuaded that this is appropriate in light of the limited nature of the application, and in light of its understanding of the nature of the transactions and the participants currently in these markets.

Consistent with this determination, the Commission is making clear that this exemption remains applicable to transactions that result in risks relating to making or taking delivery of the underlying physical commodities. Accordingly, the category of eligible appropriate persons for this exemption must have a demonstrable capacity or ability to make or take delivery. As the Commission explained in the Notice Proposing Issuance of an Order, at page 6252, "such capacity entails the ability to produce, refine, store, transport or otherwise tangibly control the physical commodity." This can be fulfilled, however, by *bona fide* contractual arrangements for these services.

Moreover, despite some merit in the observation that certain smaller, or start-up commercial firms may be excluded unnecessarily from eligibility for this exemption by the net worth and total assets conditions set forth in section (A)(ii) of the Order, in light of the general nature of the current participants in the markets, the Commission believes that smaller commercial firms, which cannot meet these financial criteria, should not be included. In this regard, size is a relevant proxy for measuring the expertise of, and participation in these types of markets, and for an entity's capability of making or taking delivery in these markets. Moreover, the Commission notes that even smaller or start up firms should be able to meet these financial requirements through the use of various types of permitted guarantees, and thereby qualify for this exemption. n9

n9 In this regard, although the Commission has not provided that commodity pools or other collective investment vehicles, including investment companies, or floor brokers and floor traders separately constitute classes of "appropriate persons," to the extent that such entities qualify for exemption as an eligible entity under another category of "appropriate person," they will not be excluded from the exemption. Accordingly, such entities may qualify as appropriate persons if, in connection with their business activities, they incur risks, in addition to price risk, related to the underlying physical commodities, have a demonstrable capacity or ability, directly or through separate *bona fide* contractual arrangements, to make or take delivery under the terms of the contracts, are not prohibited by law or regulation from entering into such contracts, and otherwise meet the qualifications set forth in one of the enumerated categories of appropriate persons. However, any collective investment vehicle formed solely for the purpose of entering into **Energy** Contracts will not qualify for the exemptive relief provided under the Commission's Order. Of course, a commodity pool operator will continue to be subject to Section 4o of the Act in connection with its solicitations or other activities as a CPO even though it may purchase or direct the purchase of **Energy** Contracts that are subject to the Commission's Order.

On a separate issue, one commenter requested that the final order also exempt "any person or class of persons offering, entering into, rendering advice, or rendering other services with respect to such **Energy** Contracts, in connection with such activity." The commenter reasoned that extension of relief to those advising or rendering advice or other such services in connection with these transactions, which was included in the exemption for swap and hybrid instruments, is equally applicable to this proposed exemption.

Consistent with section 4(c)(1) of the Act and the Commission's exemptions for swap and hybrid instruments, the Commission is providing that persons offering, entering into, rendering advice, or rendering other services with respect to such **Energy** Contracts are eligible for this exemption. n10

n10 As the Commission noted in the Notice Proposing Issuance of an Order, it did "not intend that the proposed condition that an **Energy** Contract be a principal-to-principal transaction preclude the use of brokers or other agents in connection with the negotiation of, or the performance or settlement of the obligations under, a contract * * *. 58 FR 6252, n.11. The final order makes clear that it encompasses agents rendering such services, including advisory services, for those activities. [*21291]

However, as explained in connection with the exemption for swap transactions, the application of this exemption to such persons

"engaged in activity otherwise subject to the Act would not be exempt for such activity, even if it were connected to their exempted * * * [**Energy** Contract] activity. Also in this regard, the Commission wishes to make clear that the exemption does not apply to any financial, recordkeeping, reporting or other requirements imposed on any person in connection with their activities that remain subject to regulation under the Act. Thus, for example, futures commission merchants must continue to account for any liabilities arising out of any * * * [**Energy**] agreement in meeting the net capital requirements of Commission Rule

1.17 just as they do in the case of other financial instruments not regulated under the Act. Similarly, the risk assessment recordkeeping and reporting requirements imposed on futures commission merchants by new section 4f(c) of the Act apply * * *."

58 FR at 5589.

Finally, several commenters suggested that the Commission clarify the role of written representations in forming a reasonable basis for the belief that a counterparty qualifies as eligible for this exemption. A second commenter requested that the Commission also clarify that a reasonable belief is required as to the counterparty's eligibility with respect to both its capacity for delivery and its inclusion as an eligible appropriate person.

These determinations, that there is a reasonable basis to believe that a counterparty is eligible to enter into the transaction both with regard to its capacity and as an appropriate person, are to be made at the inception of the transaction. Moreover, an eligible entity that has a reasonable basis to believe its counterparty is also an eligible entity when entering into a master agreement may rely on such representations continuing, absent information to the contrary. n11 Compare, 58 FR at 5589.

n11 As under the Part 35 rules, where a counterparty has ceased to be eligible for this exemption, an eligible entity nevertheless may enter into a "closing transaction" with the counterparty to terminate all obligations between them. See, 58 FR at 5589, n. 18.

D. Description of Exempt Transactions

In general, commenters agreed with the accuracy of the Commission's description of the operation of these markets in **energy** products. However, the entities which filed the application for this exemption, sought, in their comment letter, to distinguish the relative degree of individual negotiation over particular categories of the contract's economic terms. In particular, this commenter pointed out that the terms of the transactions regarding quality and location in many of these markets, because they involve "a single supply location," "are fixed and not the subject of individual negotiation."

The Commission is aware that the terms regarding the quality and location of **Energy** Contracts, as well as other conventions surrounding their trading are standardized. Nevertheless, these transactions can be distinguished by the fact that, because their credit terms are individual to the counterparties, they are not fungible and are created through the direct negotiation of the parties to the transaction. Compare, 58 FR at 5591.

Several commenters also requested that the Commission confirm that the requirement for binding delivery on the contracts is not affected by inclusion in the contract of a termination right which is triggered by an event of default, such as the insolvency of a counterparty. The Commission concurs that *bona fide* terminations occurring under the terms of a contract, for contingencies such as default or insolvency that are not expected by the parties at the time the contract is entered into, will not invalidate application of the exemption to the transaction. In this regard, however, the Commission cautions that the inclusion of such provisions, and their use, must be *bona fide* and not for the purpose of evading the terms of this exemption.

Finally, one commenter argued that the proposed order is arbitrary because it would have exempted only contracts which were bilateral and not subject to a mutual risk clearing system. n12 The CBT concluded that this is contrary to the public interest because those methods which are included within the exemptive relief are, in its view, inferior to a true clearing system, which is not included within the scope of this order. As the Commission has noted elsewhere in this release, however, this order is responsive to the application for relief and is tailored to current practices in these markets. Accordingly, the order is limited in scope to bilateral, individually negotiated instruments, which is the common practice in these markets.

n12 As the Commission noted in the Notice Proposing an Order:
"The requirement that **Energy** Contracts be bilateral and subject to individual negotiation is intended to assure that the transactions would not be subject to a clearing system where the credit risk of individual participants of the system to each other, with respect to a transaction to which each is a counterparty, would effectively be 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." -- 58 FR at 6253, n. 15.

E. Breadth of Exemptive Relief

The Commission requested comment on whether it should reserve anti-fraud jurisdiction under section 4b of the Act, 7 U.S.C. 6b, over these instruments. No commenter explicitly supported the retention by the Commission of anti-fraud jurisdiction. To the contrary, almost all of the commenters opposed reservation of this authority. Most agreed with the views expressed by one commenter that:

"[G]iven the commercial characteristics of these transactions and the significant requirements to be "commercial participants" and "appropriate persons," the [commenter] * * * does not believe that section 4 (b) (sic) of the Act (anti-fraud) should be applied to **Energy** Contracts."

In this particular instance, the Commission concurs with the commenters that it need not retain section 4b authority, to whatever extent that section of the Act would otherwise be applicable to these transactions. n13 However, sections 2(a)(1)(B) of the Act and the provisions of sections 6(c), 6c, 6(d) and 9(a)(2) of the Act, to the extent that these provisions prohibit manipulation of the market price of any commodity in interstate commerce or for future delivery on or subject to the rules of any contract market, will continue to apply. n14

n13 Of course, that is not to say that the Commission's decision not to reserve Section 4b anti-fraud jurisdiction will leave market participants without legal recourse for fraud in connection with these transactions. Market participants will continue to have available those state and common law remedies which have been applicable to these markets from their inception.

n14 Moreover, as the Commission noted in its Notice Proposing Issuance of an Order, at 58 FR 6253, n.19, this order "would not affect the applicability or protections of state law (other than gaming or "bucket shop" laws), or antifraud statutes of general applicability, to the exempted **Energy** Contracts or any other protections provided by other applicable federal laws. Congress specifically noted that, in exempting an instrument from the Act, the Commission cannot exempt it from applicable securities and banking laws and regulations." H.R. Rep. No. 978, 102d Cong., 2d Sess. 83 (1992).

Finally, several commenters requested that the Commission broaden the exemption by making its application retroactive. As proposed, the Commission's order would have been effective upon publication for all executory transactions. Various commenters objected. One reasoned that:

"[I]f the **CFTC** determines that issuing the proposed exemption is consistent with the public interest, its determination should eliminate any legal uncertainties with respect to **Energy** Contracts entered into before as well as after the effective date of the exemption. The **CFTC's** final rules exempting [*21292] certain swap and hybrid transactions apply retroactively, and * * * [the commenter] sees no reason why the proposed exemption should not also apply to existing **Energy** Contracts."

In light of the Commission's objective in issuing this order -- to provide greater legal certainty regarding the trading of these instruments -- and the uniform opinion of the commenters that the retroactivity of the order is an important component of providing that certainty, the Commission has determined that upon the order's effective date, it will apply retroactively, to all such transactions entered into on or after October 23, 1974. This is consistent with the Commission's recent promulgation of rules exempting certain swap transactions, 58 FR 5587, and certain hybrid instruments, 58 FR 5580 (January 22, 1993).

F. Public Interest and Purposes of the Act Determinations

1. Public Interest

In determining that its actions are consistent with "the public interest and the purposes of" its enabling statute, an agency, such as the Commission, applies the standard against the template of its over-all regulatory scheme. In this regard, the Conference report states that the "public interest" under section 4(c) includes the "national public interests noted in the [Act], the prevention of fraud and the preservation of the financial integrity of the markets, as well as the promotion of responsible economic or financial innovation and fair competition." H.R. Rep. No. 978, 102d Cong., 2d Sess. 78 (1992). n15 The Conference Report goes

on to state that "[t]he Conferees intend for this reference to the "purposes of the Act" to underscore their expectation that the Commission will assess the impact of a proposed exemption on the maintenance of the integrity and soundness of the markets and market participants." *Id.*

n15 One commenter, a futures exchange, in its letter notes that in addressing certain elements of the public interest for futures trading, Congress has indicated that contract market designation and regulation under the Act is necessary to avoid creating an undue burden on commerce. *See* Section 3 of the Act. Seventy years after the enactment of Section 3, however, Congress enacted Section 4(c) authorizing exemptions from Section 4(a) of the Act, for certain products, because "traditional futures regulation * * * may create an inappropriate burden on commerce." H.R. Rep. No. 978, 102d Cong., 2d Sess. 80 (1992).

Energy Contracts are used by certain commercial entities that are engaged in the production, refining, processing or merchandising of crude oil, condensates, natural gas, natural gas liquids, or their derivatives which are used primarily as an **energy** source. **Energy** Contracts are used by these entities and other commercial entities in the conduct of their businesses. Reportedly, these markets have been chilled by the legal uncertainty surrounding these transactions. The Order should reduce uncertainty, thus allowing participants to negotiate and structure **Energy** Contracts in ways that most effectively address their economic needs, and thereby enhancing the global competitive position of U.S. businesses.

As noted by one commenter,

"Congress, when considering passage of the [Futures Trading Practices of 1992], acknowledged that the mandatory exchange-trading requirement, if applied to every commodity transaction having the indicia of a futures contract, may cause foreign market participants to engage in such transactions outside of the United States, creating "competitive disadvantages for U.S. participants."

2. Material Adverse Effect on Regulatory or Self-Regulatory Responsibilities

In making this determination, Congress indicated that the Commission is to consider such regulatory concerns as "market surveillance, financial integrity of participants, protection of customers and trade practice enforcement." n16

n16 H.R. No. 978, 102d Cong., 2d Sess. 79 (1992).

The record before the Commission does not support a conclusion that the purpose of the Act or the Commission's regulatory efforts thereunder have been adversely affected by the use of **Energy** Contracts or will be so by the issuance of the order. **Energy** Contracts have been entered into by commercial participants in the **energy** markets for a number of years, without any apparent adverse impact on market surveillance, financial integrity of participants, protection of customers and trade practice enforcement of regulated markets.

Specifically, the Commission has addressed concerns regarding financial integrity and customer protection through the requirement that **Energy** Contracts may only be entered into and/or only be transacted on behalf of "appropriate persons", as defined above. This approach ensures that such transactions involving **Energy** Contracts will be limited to sophisticated entities engaged in the businesses described above and who are financially able to bear risks associated with such transactions. n17

n17 In enacting the 1992 Act, Congress explicitly authorized exemptions from all provisions of the Act (except section 2(a)(1)(B)) and simultaneously enacted a " conforming amendment" to section 12(e)(2) explicitly acknowledging that State antifraud statutes of general applicability would continue to apply to exempted transactions.

The Commission also noted that the existence of **Energy** Contracts to date has not affected the ability of futures exchanges to fulfill their self-regulatory duties. n18 In this regard, commenters have asserted that the futures market and the **Energy** Contract markets are linked, with many of the same commercial entities using **Energy** Contracts also using the **energy** futures markets for hedging purposes. By creating a more

certain legal environment for **Energy** Contracts, the potential for systemic risk due to disaffirmance of such contracts as invalid under the Act is reduced, and there is no reason to conclude that the exchanges' self-regulatory responsibilities will be adversely affected by permitting transactions under **Energy** Contracts to continue on this basis. n19

n18 In this respect, neither of the two futures exchanges commenting on the proposal indicated that the proposed order will adversely affect their self-regulatory responsibilities.

n19 The Commission is unaware of any **Energy** Contracts that provide for settlement by tendering an exchange-created delivery instrument, such as an exchange-approved depositary or depository receipt or shipping certificates, that is specified in the rules of any designated contract market. **Energy** Contracts which did specify such delivery instruments could have an effect on certificated supplies for settlement of designated futures or option contracts and, accordingly, the creation of **Energy** Contracts specifying such delivery instruments should only occur after consultation with the Commission.

3. Anticompetitive Considerations

Section 15 of the Act provides, in relevant part, that the Commission must consider the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives, policies, and purposes of the Act in adopting any rule, regulation, or exemption under section 4 (c). n20 Thus, a formal analysis under the antitrust laws is not, by itself, dispositive of the issues raised by a Commission action. n21 As a result, the Commission is not compelled by section 15 to take the least anticompetitive course of action. Rather, where alternatives with varying degrees of regulatory benefit exist, the [*21293] Commission may adopt the approach that appears to be the most likely to achieve the objectives, policies, and purposes of the Act, even if that approach is not the least anticompetitive. n22

n20 Specifically, section 15, as amended by section 502(b) of the 1992 Act, provides:
"The Commission shall take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of this Act, as well as the policies and purposes of this Act, in issuing any order or adopting any Commission rule or regulation (including any exemption under sections 4(c) or 4c(b), or in requiring or approving any bylaw, rule, or regulation of a contract market or registered futures association established pursuant to section 17 of this Act."

n21 See *Gordon* v. *New York Stock Exchange,* 422 U.S. 659, 690-691 (1975); *Silver* v. *New York Stock Exchange,* 373 U.S. 341 (1963).

n22 See, e.g., *British American Commodity Options Corp.* v. *Bagley,* Comm. Fut. L. Rep. (CCH), 20,245 at 21334 (S.D.N.Y. 1976), *aff'd in part and rev'd in part,* 552 F.2d 482 (2d Cir. 1977), *cert. denied,* 434 U.S. 938 (1977).

Accordingly, section 15 requires the Commission to balance the likely anticompetitive impact of its action against the objective, policy, or purpose of the Act which that action may further. And, although the Commission must consider the public interest in maintaining or promoting competition, it need not weigh this interest equally against an objective, policy or purpose of the Act being served in reaching its final determination.

The Commission's consideration of the proposed order and its evaluation of the comments received in this regard has led it to conclude that any possible anticompetitive effects are clearly outweighed by the order's furtherance of the policies, purposes and objectives of the Act. First, the proposal does not appear to raise any significant competitive issues. As a number of commenters noted, the exemption, by improving the legal certainty of **Energy** Contracts, will reduce the risk that the physicals market may be disrupted. Commenters

also noted that granting the exemption could result in expanded participation by foreign and domestic **energy** companies. Accordingly, the exemption furthers a fundamental objective of section 4(c)(1) of the Act, i.e., promoting "responsible economic or financial innovation and fair competition."

For the reasons explained above, the Commission, based upon the appropriate determinations made in accordance with the standards set forth in section 4(c) of the Act, hereby issues the following Order:

Order of the Commodity Futures Trading Commission Exempting From Regulation (Except as Specified) Certain Energy Contracts

Whereas, it is the Commission's understanding, based upon representations contained in an Application for Exemption, dated November 16, 1992, that contracts for the purchase and sale of crude oil, condensates, natural gas, natural gas liquids, or their derivatives which are used primarily as an **energy** source, by their terms, impose binding delivery obligations on the parties ("**Energy** Contracts"). These **Energy** Contracts do not provide either party with the unilateral right to offset the contract or to discharge its obligation under the contract by a cash payment, except pursuant to a *bona fide* term of the contract permitting the unilateral termination of the contract for force majeure, insolvency or bankruptcy of one of the parties, default or other inability to perform, unexpected at the time the contract is entered into (*"bona fide* termination right"). **Energy** Contracts thus expose the counterparties to the substantial economic risk of a commercial cash market transaction in which delivery of the product is required pursuant to the terms of the contract. Further, **Energy** Contracts are entered into between principals; and their material economic terms (including, in particular credit terms) are subject to individual negotiation between the parties. n23

n23 Parties to **Energy** Contracts may establish bilateral collateral or other credit protection arrangements, such as a letter of credit or other documentation of funds availability, to address credit issues.

The Commission further understands that parties to **Energy** Contracts satisfy or otherwise settle their obligations through several types of commercially acceptable arrangements, including the seller's passage of title and the purchaser's payment and acceptance of the commodity underlying the contract. n24 Passage of title and acceptance of the commodity constitutes performance under a *bona fide* contract regardless of whether the buyer lifts or otherwise takes delivery of the cargo or receives pipeline delivery, or as part of a subsequent separate contract, passes title to another intermediate purchaser in a "chain", "string" or "circle" within a "chain."

n24 Cash market transactions in crude oil, petroleum products, natural gas and natural gas liquids, as well as other **energy** related commodities in which physical delivery is made, are effected through payment by the buyer and transfer of title by the seller to the buyer.

The physical delivery obligation specified in an **Energy** Contract entered into between two parties can also be satisfied through various other arrangements between the parties. For example, in the case of crude oil and crude oil products, the physical delivery obligation could be satisfied by exchanging one quality, grade or product type for another quality, grade or product type. Such transactions are referred to in the industry as "grade and/or quality swaps" or "exchanges." In addition, the obligation could be satisfied by location swaps.

In addition, two parties to an **Energy** Contract may enter into a bilateral "netting" or other similar agreement, subsequent to the execution of an **Energy** Contract. n25 Under such an agreement, the two parties agree to "net" or "book out" the obligations imposed under two or more **Energy** Contracts which provide for delivery of the same commodity at the same delivery location and during the same delivery period and thus cancel each other. Such a netting agreement can be entered into at the time that the canceling **Energy** Contract is originated, or subsequently, through a different agreement, at a time prior to when performance on the contracts otherwise would be due. n26

n25 In the **energy** markets, the terms "book out" (crude oil) and "book transfer" (other petroleum products) are cash market terms that generally refer to the cancellation or netting of physical delivery obligations between parties, the primary purpose of which is to prevent or minimize the uneconomic movement of the physical commodity.

n26 Rather than agreeing to net particular canceling **Energy** Contracts, two frequent counterparties, for purposes of ease of administration, may use a "master," or other form of bilateral agreement to achieve the same result. This master agreement, established prior to entry into the **Energy** Contracts, provides that the two counterparties agree to net **energy** Contracts of the same commodity at the same location and during the same delivery period. This agreement replaces the practice that counterparties agree to net particular canceling **Energy** Contracts, either to the time the second contract is entered into, or by a separate, subsequent agreement, with the understanding that all contracts between them which cancel each other will be netted, unless they have agreed not to apply the prior netting agreement at the time of entry into an **Energy** Contract.

The Commission further understands that under current market practice, the parties to the original contract may enter into a subsequent agreement ("second contract") which provides for settlement in a manner other than by physical delivery. The second contract, however, cannot stand alone as an independent transaction; it is incidental to a pre-existing, *bona fide* **Energy** Contract. Moreover, the establishment of the second contract cannot be made a pre-condition of the initial **Energy** Contract; *e.g.*, one party cannot require its counterparty to agree in advance to the establishment of the second contract as a condition of acceptance of the initial **Energy** Contract. Accordingly, the second contract is a separately negotiated agreement and, if the counterparty subsequently does not agree to the second contract, the parties remain obligated in accordance with the binding delivery requirements imposed under the initial **Energy** Contract.

Existing market practice also permits three or more parties, upon finding that they form a "chain", or a "string" or "circle" within a "chain", to satisfy their obligations under an **Energy** Contract, whether or not title passes or [*21294] is deemed to pass, through a subsequent, separate agreement, with unanimous consent of the parties, to "book out" and satisfy their obligations through separately negotiated bilateral cash payments or other mutually acceptable terms. It has been represented to the Commission that such arrangements are common in the **energy** cash market. n27 They are standard commercial practice to avoid and/or minimize transaction costs, non-economic payments and product movements, and for reducing the number of transactions necessary to perform all obligations between parties pursuant to the contracts which are "booked out."

n27 The use of brokers, agents or a third-party to identify the existence of a "chain" or to facilitate the bilaterally negotiated "book out" of transactions forming a "chain" is not deemed to constitute a clearing system. The Commission has been advised that there are a number of third-party brokers and agents who provide this service in the **energy** cash market.

And whereas, this order is limited to

(A) commercial participants who, in connection with their business activities: (1) incur risks, in addition to price risk, related to the underlying physical commodities; (2) have a demonstrable capacity or ability, directly or through separate *bona fide* contractual arrangements, to make or take delivery under the terms of the contracts; (3) are not prohibited by law or regulation from entering into such **Energy** Contracts; (4) are not formed solely for the specific purpose of constituting an eligible entity pursuant to this Order; and (5) qualify as one of the following entities:

(i) A bank or trust company;

(ii) A corporation, partnership, proprietorship, organization, trust, or other business entity with a net worth exceeding $ 1,000,000 or total assets exceeding $ 5,000,000, or the obligations of which under the agreement, contract or transaction are guaranteed or otherwise supported by a letter of credit or keepwell support, or other agreement by any such entity or by an entity referred to in subsections (A), (B), (C), (H), (I) or (J) of section 4(c)(3);

(iii) A broker-dealer subject to regulation under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.);

(iv) A futures commission merchant subject to regulation under the Act; or

(B) Any governmental entity (including the United States, any state, any municipality or any foreign

government) or political subdivision thereof, or any multinational or supranational entity or any instrumentality, agency, or department of any of the foregoing;

And whereas, this order also encompasses persons offering, entering into, rendering advice or rendering other services with respect to the agreement, contract, or transaction which is the subject of this Order, for such activity;

The Commission, pursuant to section 4(c) of the Act, hereby exempts from all provisions of the Commodity Exchange Act, 7 U.S.C. 1 *et seq.*, except sections 2(a)(1)(B) of the Act and the provisions of sections 6(c), 6c, 6(d) and 9(a)(2) of the Act, to the extent that these provisions prohibit manipulation of the market price of any commodity in interstate commerce or for future delivery on or subject to the rules of any contract market, the following transactions, entered into on or after October 23, 1974:

Contracts for the purchase and sale of crude oil, condensates, natural gas, natural gas liquids or their derivatives which are used primarily as an **energy** source, and which:

(1) Are entered into by and between participants covered by this Order, having at initiation of the contract a reasonable basis to believe that its counterparty is also within the terms of this Order;

(2) Are bilateral contracts between two parties acting as principals, the material economic terms of which are subject to individual negotiation by the parties; and

(3) Impose binding obligations on the parties to make and receive delivery of the underlying commodity or commodities, with no right of either party to effect a cash settlement of their obligations without the consent of the other party (except pursuant to a *bona fide* termination right), *provided, however,* that the parties may enter into a subsequent book out, book transfer, or other such contract which provides for settlement of the obligation in a manner other than by physical delivery of the commodity specified in the contract.

Issued in Washington, DC, this 13th day of April, 1993, by the Commission (Acting Chairman Albrecht and Commissioner Dial concurring, Commissioner Bair dissenting).

Jean A. Webb,

Secretary of the Commission.

Concurring Opinion of Acting Chairman William P. Albrecht

Today we have before us an exemption for large commercial participants in off-exchange **energy** based transactions. These transactions compose a large ongoing market for **energy** products of importance to U.S. and international commerce. We are considering this exemption in response to a petition submitted by several market participants who seek further certainty that this market is outside **CFTC** regulatory jurisdiction.

This market for **energy** products has been in existence for many years and over those years it has grown in size, importance and complexity. The Commission has never regulated this market, nor has it sought to regulate it. The market is characterized by principal to principal transactions between large sophisticated commercial entities. The Commission is not aware of fraudulent practices perpetrated against the general public by the participants in this market, nor indeed have any of the commercial participants in this market complained to the Commission of fraudulent practices by other participants. Also, there generally do not appear to be any concerns about the ability of these market participants to perform their obligations. Absent two events it is doubtful that the petitioners would have brought their request to us.

First, a vast number of transactions previously not considered to be within the scope of the Commodity Exchange Act were brought into question by a single court decision, *Transnor (Bermuda)* v. *BP North America Petroleum*, that applied the CEA to a foreign market of mostly commercial to commercial transactions. The Commission did not believe these transactions were the off-exchange "futures" contracts that Congress intended to prohibit and the Commission issued a statutory interpretation to that effect. Obviously, the parties in the 15 day Brent Market -- major international oil and trading companies -- should not have been able to escape their contractual obligations in these transactions by claiming the transactions were void as illegal futures contracts.

Second, the Commission's new exemptive authority granted by Congress in the Futures Trading Practices Act

of 1992 frees the Commission from the constraints of the futures/forwards dichotomy. In this regard the exemptive authority allows the Commission to approach situations on a case by case basis. This freedom to try new approaches is the real value of the exemptive authority. The Commission is now able to review petitions or requests for exemption on a public policy basis in light of the seventy year history of regulating futures contracts as well as the current and expected needs of commerce.

I believe that public policy dictates that the Commission exempt the market before us today from Commission regulation. There does not appear to be any reason sufficient to justify Commission regulation, nor any necessity for the Commission to involve itself in this market. I view this market, [*21295] its transactions, and participants as clearly within the scope intended by Congress for the exercise of the Commission's new exemptive authority. Indeed, in enacting the exemptive authority Congress specifically directed us to address the crude oil market.

Some have argued that the Commission should not exempt these markets from the anti-fraud requirements of section 4b of the CEA. I disagree. First, in this commercial to commercial market there has not been shown any need for the Commission to take any action to prevent fraud. Second, as the Commission will not be involved with ongoing regulation of this market, or even be more than generally knowledgeable of the activities in this market, it will not possess the information necessary to enforce Section 4b. Third, the presence of 4b will be of little potential benefit and great potential harm. The terms of 4b limit its application to futures contracts entered into for or on behalf of a customer -- serious limitations where the transactions are largely principal to principal and where the individual transactions would have to be proved to be futures contracts. Further, if a party to one of these exempt transactions were to seek to base a complaint on Section 4b, they would face the problem that the Commission has also chosen to exempt this market from section 22 of the Act, thus they may not have any right to bring a private action under the CEA. The potential harm of maintaining 4b jurisdiction is that such action on one hand may hinder the development of this market, undermining the legal certainty we seek to assure today and on the other hand give some the illusion of federal supervision by the **CFTC,** when in fact the **CFTC** does not and can not supervise this market.

Exemptive Order for Certain Energy Contracts, Concurring Opinion of Commissioner Joseph B. Dial

After the enactment of the FTPA, we find ourselves in the peculiar situation of possessing an exemptive authority that does not require our determination that something is a futures contract in order to exempt if from our jurisdiction. At least that's what the conference report language tells us.

Accordingly, we have worked diligently to avoid stepping on the legal and policy land mines inherent in this authority. I have gone over the new law and the conference report, as well as the case law and Commission interpretations in the area of forward contract definition. In light of concerns regarding Section 4b of the Act and this exemption, and the differing institutional opinions on this issue, I'd like to make clear how I view this exemption.

First, it is understandable that people make a comparison between the swaps and hybrids exemptive authority this Commission exercised in January, and the exemptive authority we are approving today. We are new at this endeavor, and so have little background as an institution in using this particular authority. Therefore, I think it is important to note some of the differences I see between today's exercise and the exemptive action the Commission took on January 14, 1993.

The forwards markets are understood to be fundamentally different from the swaps markets. In effectuating the swaps exemptive authority, we did not have the longstanding institutional experience that we do with forwards markets and their evolution. Swaps are a relatively new field of complex financial transactions, and are still the object of intense study by the government and the private sector. Therefore, the Commission deemed it prudent to retain 4b so that, for example, if in the unlikely event an unscrupulous entity were to convolute a swaps transaction into a boilerroom-type futures transaction, we could act expeditiously against such conduct.

Conversely, with the exercise of exemptive authority as to the **energy** contracts in current usage as described in this proposal, we have extensive legal and policy background relating to these well-known commercial markets.

As my colleagues are aware, I take a strong pro-enforcement stance in the investigation and prosecution of fraud in the markets we regulate. However, after reviewing the current request for exemption for existing markets, and in light of the Brent interpretation and the continuing evolution of these commercial transactions, I believe it more proper, from a policy and legal standpoint, not to retain 4b authority as to

contracts described in this exemption. I came to this view after interpreting the conference report language regarding the use of exemptive authority in this area to indicate a need for clarification of our Brent interpretation. While I recognize that this exemption is regarded as an expansion of Brent, I view our action here today to be in accordance with the Congressional directives in the FTPA. Therefore, I've concluded that 4b should not be retained regarding exemptive authority for existing practices in these **energy** contracts.

If, after approval today, someone commits a fraudulent act relating to what appears on the surface to be an exempt **energy** transaction within this proposal, but is proven later to be a futures contract outside the parameters of this proposal, then the Commission of course has authority to prosecute that fraudulent conduct under 4b.

This exemption is unique, given its factual and legal background. I believe that by approving it we are exercising our exemptive authority in a manner consistent with Congressional intent. We are allowing existing **energy** contract practices in these markets, whose historical record is well-documented, to continue to perform a useful function in the international marketplace.

Dissenting Opinion of Commissioner Sheila Bair

Mr. Chairman. I have decided, albeit reluctantly, to vote against the final order before us today because of its failure to retain the general anti-fraud provisions contained in section 4b and 4o of the Commodity Exchange Act. Let me just briefly summarize the policy reasons why I believe we should retain such authority in the **energy** exemptive order.

In my view, the final order, by its terms, is not limited to forward contracts traditionally excluded from the jurisdiction of this agency. Rather, it goes significantly beyond the forward contract exclusion and extends to transactions which could very well meet the criteria for illegal off-exchange futures contracts traditionally applied by this agency and the courts. I believe that exempting such transactions from statutory provisions as basic and central to our regulatory scheme as Sections 4b and 4o is a serious misapplication of our new exemptive authority, and sets a dangerous precedent.

The Proposed Order Goes Beyond the Forward Contract Exclusion

As I stated, the order, by its terms, is not limited to forward contracts. Further, the fact that we are proceeding with an exemption from our jurisdiction, as opposed to describing a class of excluded transactions, demonstrates implicit recognition that some of the transactions which we are exempting could indeed be futures. Moreover, markets which qualify for this exemption operate very differently from traditional forward markets. The contracts are standardized, there is a large amount of speculative activity, and the overwhelming majority of transactions do not result in delivery, but are cash settled.

Indeed, the only arguable distinguishing feature between exempt transactions under the order and the typical gasoline boiler room operation is [*21296] the requirement that participants be commercial entities. Yet, the "commerciality" requirement in the order is by and large undefined. Moreover, the Commission, has never recognized an exemption to its jurisdiction based solely on the "commerciality" of the participants, nor can I see any policy reason why commercial firms engaging in futures transactions should not have the basic protection of our anti-fraud provisions.

The "Sophistication" of Market Participants is Not a Valid Basis for Providing an Anti-Fraud Exemption

It has been argued that because the participants in exempt **energy** transactions are "sophisticated" institutional users or entities of high net worth, they don't "need" **CFTC** anti-fraud protections.

At the outset, I would note that if we are to rationalize exemptions from anti-fraud and other components of our regulatory scheme on the basis of the "sophistication" of market users, we might as well close our doors tomorrow, because approximately 98% of users of regulated, exchange-traded futures meet the eligibility rquirements of our swaps rule, and, these financial requirements are much higher than those in the order. Moreover, large firms are defrauded -- we have brought a number of enforcement actions where the victims have been so-called institutional or sophisticated investors. I would also add that this order does allow for indirect public participation through collective investment vehicles, and through the guarantee provisions in paragraph ii of the appropriate person portion of the order.

The Existence of State Anti-Fraud Remedies is Irrelevant to the Issue at Hand

In addition, I do not view the existence of state anti-fraud remedies as a valid policy basis for providing an exemption from the CEA's basic anti-fraud protections. State remedies are always available in the absence of federal protections. It is important to remember that it was the historical inadequacy of state law protections, however, that gave rise to federal regulation of financial markets in the first place.

Retaining Residual Anti-Fraud Authority Would Not Place An Onerous Burden on the Markets

I also do not believe that we would place an onerous burden on the markets by retaining anti-fraud authority.

If we retained 4b and 4o, they would apply to those fraudulent transactions which we could demonstrate were futures contracts and thus otherwise subject to the CEA. In addition, since we are preserving the Brent Oil statutory interpretation, defendants would still be able to rely on that document as a shield against **CFTC** actions. Moreover, participants in these markets have always run the risk that transactions which do not meet the statutory interpretation could be deemed "futures" and thus subject to the whole plethora of CEA requirements, not just anti-fraud prohibitions. That is precisely why we are moving forward with this order. Is it really that much of a burden on market participants to retain a sliver of authority regarding fraudulent activity?

It should also be emphasized that 4b and 4o apply no more of an onerous burden on these markets than does state anti-fraud law. Indeed, given conflicts in state law, providing federal forums and remedies to these transactions is, if anything, less onerous.

Providing an Anti-Fraud Exemption Would Set a Dangerous Precedent and Is Unnecessary Given Our New Exemptive Authority

Finally, I think we are setting a dangerous precedent by not retaining anti-fraud authority. I can see no valid policy reason why to decide to retain anti-fraud authority in our swaps rule, yet to decline to do so here. My fear is that we will inevitably raise the expectations of other potential applicants for exemptive relief that they will also be able to escape Sections 4b and 4o.

What is especially frustrating to me is that we do not need to paint ourselves into this corner. The main reason why the **CFTC** sought general exemptive authority in last year's reauthorization was so that we would have the flexibility to craft appropriately tailored exemptive relief based on public policy considerations, instead of having to deal with the "all or nothing" jurisdictional decisions we had to make in the past. Yet, we are still following this "all or nothing" approach, when in my view, we should be carefully weighing individual aspects of our regulatory structure and making a reasoned determination as to which requirements should and should not apply to a particular class of transactions. And, for the reasons I have stated, I do not believe the case has been made for providing an exemption from basic anti-fraud provisions.

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