EXHIBIT B

U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5000
Facsimile: (202) 418-5521
www.cftc.gov

January 31, 2007

Mr. John Labuszewski
Managing Director
Research and Product Development
Chicago Mercantile Exchange
20 South Wacker Drive
Chicago, Illinois 60606-7499

Re: Request of review and approval of three new Chicago Mercantile Exchange Credit Event futures contracts, based upon three reference entities, Centex Corp., Jones Apparel Group, Inc., and Tribune Corporation

Dear Mr. Labuszewski:

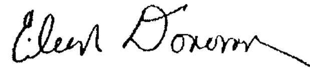
In correspondence to the Commission dated October 17, 2006, October 18, 2006, and October 24, 2006, the Chicago Mercantile Exchange (CME) requested product review and approval of three new CME Credit Event futures contracts, based upon the reference entities Centex Corp., Jones Apparel Group, Inc., and Tribune Corp., pursuant to Section 5c(c)(2) of the Commodity Exchange Act (Act) and Commission Regulation 40.3. On January 12, 2007 and January 16, 2007, the CME voluntarily amended the contracts' terms and conditions to define a credit event as a bankruptcy of the reference entity. In those amendment filings, the CME agreed to a 15-day extension in the statutory review period until January 31, 2007. The Commission posted all of the filings on its website with a request for public comment and received responsive comments from the Chicago Board Options Exchange, the Options Clearing Corporation and the CME.

After having reviewed in detail the entire record in this matter, including the comments received, the January 26, 2007 Memorandum of the Division of Market Oversight, including the Supplemental Memorandum dated January 30, 2007, and the January 12, 2007 Memorandum of the Office of General Counsel, the Commission adopts the product analysis and legal reasoning set forth in the staff memoranda that the proposed Credit Event contracts are based on credit risk events, which are commodities, not securities. Moreover, because of the nature of the proposed contracts, the Commission has concluded that they are binary option contracts rather than futures contracts. Therefore, the contracts are commodity options subject to the Commission's exclusive jurisdiction under Sections 2(a)(1)(A) and 4c(b) of the Act.

Section 5c(c)(3) of the Act provides that the Commission shall approve any new contract or rule unless the Commission finds that the contract or rule would violate the Act. For the reasons set forth in the staff memoranda, the Commission has no basis on which to find that the

proposed Credit Event contracts and the rules associated with those contracts would violate the Act. Accordingly, please be advised that the proposed Credit Event contracts and the rules associated with those contracts were approved by the Commission as of the date of this letter.

For the Commission,



Eileen Donovan
Acting Secretary of the Commission

U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5120
Facsimile: (202) 418-5524
www.cftc.gov

Office of General Counsel

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January 12, 2007

CONFIDENTIAL MEMORANDUM

TO: The Commission

FROM: Nanette R. Everson
General Counsel

RE: *CME Credit Event Contracts*

On October 17, 2006, the CME requested prior approval of certain credit event contracts from the Commodity Futures Trading Commission ("CFTC" or "Commission") and you have asked whether the CFTC may lawfully disapprove these contracts. *See* Section 5c(c)(2) of the Commodity Exchange Act ("CEA" or "Act"), 7 U.S.C. § 7a-2(c)(2), and CFTC Rule 40.3(a).[1]

Although this request presents issues of first impression, based on our conclusion that the CME's credit event contracts are options on commodities rather than options based on the value of securities, we conclude that the Commission has no authority to withhold approval of these contracts.[2]

<u>Executive Summary</u>

Section I describes the credit event contracts which CME intends to list and trade.

Section II discusses the CFTC's and the Securities and Exchange Commission's ("SEC") jurisdiction over options on commodities, options on securities, and options on instruments that are both commodities and securities.

[1] This section provides for a 45-day Fast-Track review period under Commission Regulation 40.3(b), which ended on December 1, 2006, and the 90-day statutory review period pursuant to CEA Section 5c(c)(2)(C) ends January 16, 2007. Pursuant to the delegated authority of Commission Regulation 40.7(a)(1), the Director of the Division of Market Oversight, with the concurrence of the General Counsel, can extend the 45-day Fast-Track review period by up to 45 days. The Director extended the review period for 45 days on November 29, 2006. On January 12, 2007, the CME filed a revised application. Our analysis is based upon the original filings.

[2] Section 5c(c)(3) of the Act provides that the Commission "shall approve any such new contract or instrument, new rule, or rule amendment, unless the Commission finds that the new contract or instrument, new rule, or rule amendment would violate this Act." 7 U.S.C. § 7a-2(c)(3). We have analyzed this issue in light of the Administrative Procedure Act's prohibition of agencies acting "in excess of statutory jurisdiction," 5 U.S.C. § 706(2)(C), permitting aggrieved persons to file suit in the event an agency engages in such action. *See generally* 5 U.S.C. §§ 701 – 706.

Section III contains our analysis. First, CME's contracts are based on "credit risk" events, which are excluded commodities under the CEA. Second, CME's contracts are based either on swaps or the functional and economic equivalent of ISDA credit default swaps, which the CFMA has specifically excluded from the definition of securities. Third, Section III shows why the contracts are options based solely on commodities, thus falling under the CFTC's exclusive jurisdiction.

Section IV analyzes the views of certain commenters that CME's credit event contracts are options based on the value of securities subject to the SEC's sole jurisdiction and expresses why these views were found to be less persuasive.

I. Background

The CME is requesting approval of contracts covering three reference entities: Centex Corporation, Jones Apparel Group, and Tribune Corporation.[3] The payment terms of the CME's contract will operate from the same set of credit events that define the International Swaps and Derivatives Association ("ISDA") over-the-counter credit default swap agreement.[4] The contract seller's payment obligation would be triggered by the occurrence of any one of six credit events: (1) bankruptcy; (2) obligation acceleration; (3) obligation default; (4) a failure to pay; (5) repudiation or moratorium; or (6) restructuring. According to the CME, these are the six events that are specified in the standard ISDA derivatives documentation as payment triggers for over-the-counter credit default swaps contracts.[5] As such, the CME contract has been described as an "exchange-traded version" of the over-the-counter ISDA contract.

Each contract will begin trading five years in advance of the contract's final settlement date. Each contract will be cash-settled and traded exclusively through Globex. The contract seller's event-driven payment obligation will be expressed as a percentage amount of $100,000 of credit protection coverage. If a credit event occurs, the seller will be obligated to pay this

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[3] The Chicago Board Options Exchange ("CBOE"), a national securities exchange registered with the Securities and Exchange Commission ("SEC") recently filed with the SEC proposed credit related contracts. While both the CME and CBOE contracts have binary pay-out terms, there are also critical differences between the two; *e.g.,* CBOE's product is directly anchored in "the underlying security of an issuer;" CBOE's credit default options are specifically designated by reference to a "Reference Obligation" comprised of registered debt securities of an issuer. The SEC has not yet published CBOE's proposal in the Federal Register for comment but the filing is available from CBOE's website.

[4] The CME currently lists exchange-traded futures contracts on swap agreements, including 2-, 5- and 10-year interest rate swaps transactions. CBOT and NYMEX also list exchange-traded contracts based on over-the-counter swaps.

[5] The CME explains that the descriptions of these credit events may refer to a corporate obligation. Thus, obligation default may mean default on a corporate bond, bank loan or other evidence of corporate indebtedness; a sovereign debt obligation; asset-backed securities including commercial mortgage backed securities; or, possibly other debt instruments, and that these obligations may be issued by various reference entities, including corporations and sovereign entities. CME also states that these credit events are defined in Article IV of the 2003 ISDA Credit Derivatives Definitions, and that these definitions have been established as widely-recognized standards that have widespread use in the over-the-counter market. *CME Submission* at 7.

percentage amount. The contract buyer will make a payment upon entering a contract, but no further payments will be made by the buyer, except through the margining process. Absent the occurrence of a credit event, the value of the seller's payout obligation will decline to zero at contract expiration.

The CME's submission was posted on the Commission's website for public comment. The CBOE and the Options Clearing Corporation ("OCC") filed comment letters objecting to the proposed contracts on the grounds that they are subject to the sole jurisdiction of the SEC. The CME contends that its contracts are futures.

While the CME labels the products as futures contracts, in our view, they are options—they would be "unilateral" (insofar as the contract buyer makes only one payment); only the contract seller would have the binding "binary" payout obligation subject to an accelerated automatic exercise if the credit event occurs before contract expiration. Thus, taken in the whole, the contracts lack the "bilateral" characteristics associated with futures contracts. *See generally*, Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 Fed. Reg. 39656-02 (Sept. 20, 1985) (Interpretive Statement of the CFTC Office of General Counsel); *Stechler v. Sidley, Austin, Brown & Wood, LLP*, 382 F. Supp. 2d 580, 595 (S.D.N.Y. 2005) (digital options); *CFTC v. U.S. Metals Depository Co.*, 468 F. Supp 1149, 1154-1155 (S.D.N.Y. 1979). For purposes of this memorandum, we assume the proposed contracts are options.[6]

II. Jurisdictional Boundaries Between the CFTC and SEC Over Options

In attempting to discern congressional intent, we start with the relevant statutory texts. CEA Sections 2(a)(1)(A)[7] and 4c(b)[8] confer on the CFTC exclusive jurisdiction over options on

[6] Because we conclude as discussed below that the underlyings of CME's credit event contracts are not securities but are solely commodities under the CEA, even if the CME's contracts were found to be futures contracts, they would fall under the CFTC's exclusive jurisdiction. In this regard, the CFTC has exclusive jurisdiction over futures contracts on commodities, while it shares jurisdiction with the SEC over security futures products, which include futures contracts on securities. *See* CEA Section 2(a)(1)(D), 7 U.S.C. § 2(a)(1)(D). Thus, whether the CME's credit event contracts are characterized as futures contracts or options, the contract would be traded under the CFTC's exclusive jurisdiction.

[7] Section 2(a)(1)(A) of the CEA, 7 U.S.C. § 2(a)(1)(A), provides that the Commission has "exclusive jurisdiction . . . with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an "option" . . .)."

[8] Section 4c(b) of the CEA provides:

> No person shall offer to enter into, enter into or confirm the execution of, any transaction involving any commodity regulated under this Act which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty", contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe. Any such order, rule, or regulation may be made only after notice and opportunity for hearing, and the Commission may set different terms and conditions for different markets.

7 U.S.C. § 6c(b) (2000).

a commodity. *Board of Trade of the City of Chicago v. SEC*, 677 F.2d 1137, 1142 (7th Cir. 1982), *vacated as moot*, 459 U.S. 1026 (1982) (CFTC's "exclusive" jurisdiction covers commodity options); *CFTC v. American Board of Trade*, 803 F.2d 1242, 1248 (2d Cir. 1986) ("Section 4c(b) refer[s] to any transaction 'involving *any commodity* regulated under this chapter.'") (emphasis in original). CEA Section 1a(4), in turn, is extremely broad. It defines a commodity to include "all other goods and articles . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." *See also* CEA Section 1a(13) (definition of excluded commodity).

Notwithstanding the CFTC's exclusive jurisdiction over options on commodities, CEA Section 2(a)(1)(C)(i) confers sole jurisdiction on the SEC concerning "option[s] on one or more securities, (as defined in Section 2(1) of the Securities Act of 1933 and Section 3(a)(10) of the Securities Exchange Act of 1934 on the date of enactment of the Futures Trading Act of 1982), including any group or index of such securities, or any interest therein *or based on the value thereof*." 7 U.S.C. § 2(a)(1)(C)(i) (emphasis added). Similarly, options in which the underlying involves both a security *and* a commodity fall under SEC jurisdiction. *Cf. Chicago Mercantile Exchange v. SEC*, 883 F.2d 537, 539 (7th Cir. 1989). Thus, if an option is based neither upon an underlying security, nor upon "the value thereof," then the SEC has no jurisdiction over the product.

The meaning of the text "option on one or more securities," is relatively clear, but the meaning of the text "or based on the value thereof" is less clear and thus subject to regulatory and, ultimately, perhaps, judicial debate. Nevertheless, as discussed more fully in sections III and IV, we conclude that: (i) the underlying is a commodity, in particular "credit risks" or "occurrences" rather than a security; (ii) the seller's binary payment obligation will occur depending exclusively upon the occurrence of such a credit risk commodity, and not, based on the value of a security; and (iii) there has been no demonstrated evidence nor information provided to show that the relationship between the CME credit event contract and any security will be "sufficiently similar" to establish that this binary pay-out contract would fluctuate in a manner sufficiently similar to an option based on the value of a referenced security. *See Stechler*, 382 F. Supp. 2d at 596.

III. CME's Credit Event Contracts Are Not Security Options But Are Commodity Options

There are two alternative bases for concluding that CME's credit event contracts are not security options. First, CME's credit event contracts are based on "credit risk[s]" or "occurrences" that are "beyond the control of the parties to the relevant" events, and the CEA defines these as commodities, 7 U.S.C. §§ 1a(4), (13)(i) and (iv), while the securities laws do not define them as securities. Second, CME's credit event contracts are so related to and in certain significant aspects specifically based upon the terms of credit default swap agreements, so as to be the swaps' functional and economic equivalent, and swaps are statutorily excluded from the definition of a security. Thus, CME's credit event contracts are not options on securities, but are options based solely on commodities in light of the CEA's broad definition of commodity, which includes "services, rights and interests." CEA Section 1a(4). *See also* CEA Section 1a(13).

A. CME's Contracts Are Based on Credit Risk Events That Are Not Securities

In analyzing the statutory texts, we have concluded that the CME's credit event contracts would more likely than not be characterized as "based" on credit risk events. Credit risks are specifically included in the definition of excluded commodity, but are not included in the definition of security under the securities laws, and the CME's contracts are not otherwise based on securities. Because the credit risk events underlying CME's credit event contracts do not fall within the statutory definition of a security in the 1933 Act or the 1934 Act, nor are the contracts otherwise based on securities, the CME's credit event contracts do not come under the security option exclusion in CEA Section 2(a)(1)(C)(i).

1. CME's Contract Is More Likely Than Not Based on Credit Risk Events

The CME credit event contracts will payout upon the occurrence of six credit risk events including bankruptcy, obligation acceleration, obligation default, a failure to pay, repudiation or moratorium, or restructuring. The CME contract is not based on any specific reference security. Moreover, payments are "uncoupled" from any security. The binary payment structure, more akin to insurance than a correlated relationship between a payment and the value of an underlying security, ensures that no payment triggered by any of these events will be "based on the value" of a security as the courts have interpreted that term.

Because the binary payout value is a pre-set value, which is fixed at the time the contract is listed before any trading in the contract commences and remains fixed throughout the time the option is listed for trading on the exchange, the CME contract's price is more likely than not based upon credit risk events of a reference entity rather than "based on the value" of a security issued by a reference entity. The few cases that have discussed related issues would seem to indicate that the relationship between the value of the underlying security and the option on that underlying must be more than attenuated to meet the "based on the value thereof" definition. *See Stechler*, 382 F. Supp. 2d at 596-97. In *Stechler*, a case involving digital options (non-standard security index options), the district court, ruling on a motion to dismiss, found some plausibility to the argument that if the value of a digital option moves in relation to the movements of the underlying security index in a manner "sufficiently similar" to that of a standard option, the digital options were securities. Here, the CME contract's pre-set value cannot be characterized as "sufficiently similar" to the value of a security issued by the reference entity and therefore "based on the value of" that security as contemplated by CEA Section 2(a)(1)(C)(i).

2. Credit Risk Is Not Included in the Definition of Security, But Is Included in the Definition of Excluded Commodity

In concluding that CME's contracts are based on "credit risk" events rather than securities, we have thus far distinguished the underlying of CME's contract from a reference security in the traditional sense, such as a debt obligation. To be sure, the statutory definition of "security" is much broader. But that definition does not encompass the credit risk events underlying CME's contract. A comparison of "credit risk" events which are defined specifically as excluded commodities under Section 1a(13) and the definition of a "security" in the securities laws is illustrative. *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 132-133

(2000)(statute interpreted as a symmetrical and coherent regulatory scheme; meaning of one statute may be affected by other statutes); *Erlenbaugh v. U.S.*, 409 U.S. 239, 243 (1972)(where two statutes *in pari materia*, they are construed as if they were one statute).

CEA Section 1a(13)(i), 7 U.S.C. § 1a(13)(i), specifically defines "excluded commodity" to include "(i) an interest rate, exchange rate, currency, security, security index, *credit risk or measure*." (emphasis added).[9] Excluded commodities are not themselves excluded from the CEA's coverage. Instead, these commodities are "excluded" in the sense that they are eligible to be the underlying commodities for off-exchange contracts between certain sophisticated parties that are excluded from the Act. *See, e.g.,* Section 2(d) and (g), 7 U.S.C. §§ 2(d) and (g). Exchange-traded futures and options contracts are permitted to be and are listed on excluded commodities, such as interest rates, currencies and security indexes. As noted above, the definition of excluded commodity in Section 1a(13)(i) explicitly includes "credit risk or measure." The CME contracts' underlying subject matter is credit risk rather than market risk, and the CME states that it expects these contracts will be used for credit-related hedging purposes. The CME contracts are denominated as credit event-related transactions and will be marketed as such.

Whereas the six trigger events comfortably fit within the definition of excluded commodity under the CEA, comparable credit risk terms are conspicuously absent from the list of terms defining security in the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act"). Specifically, section 2(a)(1) of the 1933 Act defines security as follows:

> The term "security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

[9] CEA Section 1a(13)(iv) also includes as an excluded commodity:

> an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in clause (i)) that is --
> (I) beyond the control of the parties to the relevant contract, agreement, or transaction; and (II) associated with a financial, commercial, or economic consequence.

The underlying credit risk event of CME's contract also could qualify as an excluded commodity because the event is an occurrence or contingency under this section, provided that reference entity insiders are excluded as eligible traders for relevant contracts by CME rule.

15 U.S.C. § 77b(a)(1). *See also* Section 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10) (definition of security). There is no reference to credit risk or other similar term contained in this definition.

The absence of "credit risk" in the definition of security, but its inclusion in the definition of excluded commodity, is a compelling indicator of congressional intent concerning the proper classification of the CME contract's underlying in light of the CFMA's amendments to the Act and the securities laws. While Congress added the definition of excluded commodity and the specific reference to "credit risk" to the Act in the CFMA, it did not amend the definition of security in the securities laws to include credit risk or other similar term, even though the CFMA amended the definition of security to include security futures. Where Congress specifically added credit risk to the excluded commodity definition, but did not do so with respect to the definition of security in the securities laws, it can reasonably be inferred that Congress did not intend credit risk to be a security, but rather a commodity. This conclusion is buttressed by the fact that Congress contemporaneously amended the definition of security in the securities laws, showing that Congress directly considered amendments to the security definition, but chose not to add "credit risk" to that definition. *See, e.g., Keene Corp. v. United States*, 508 U.S. 200, 208 (1993)("where Congress includes particular language in one section of a statute but omits it in another . . . , it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.")(citation omitted).

3. <u>CME's Contract Is Not Otherwise Based on a Security</u>

The contract design and structure further support our legal analysis, since the contract is not otherwise based on a security. As noted above, the contract does not provide for the delivery of a security, nor is it based on the value of any security issued by the reference entity. The seller of the contract undertakes no obligation to deliver a security or to make a payment based on the value of a single security or index of securities. As such, the purchaser of the CME event contract does not acquire an ownership interest in the underlying corporation or any of the corporation's securities, or receive payment based on the value of such securities. While the credit events underlying the contract may be in relation to certain corporate debt obligations, as noted above there is no referenced corporate debt security underlying the contract.

In addition, the final settlement price also is fixed in advance of contract listing, and as a result, it cannot vary in relation to the price of any obligation issued by the reference entity specified in the contract. *CME Submission* at 3. Further, the underlying does not qualify as an investment contract and thus is not a security under *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-299 (1946) ("a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party[.]") and its progeny. *See CME Comment Letter* at 4. There is no common enterprise under the CME's contract, nor are profits expected from the efforts of others, but only if certain events occur. Although the definition of "security" also includes a catchall provision to include "any interest or instrument commonly known as a "security," there is no basis to conclude that CME's credit event contract, which is a binary option on certain credit risk events, or the credit risk

events that underlie it, are commonly known as a security.[10] Thus, CME's credit event contracts do not fall within the security option exclusion from CFTC jurisdiction in CEA Section 2(a)(1)(C)(i).

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[10] It is frequently stated that the definition of an investment contract security is a "flexible, rather than a static principle" that is "capable of adaptation to meet the countless and variable schemes" devised by investment promoters and that courts often construe securities laws broadly in order to achieve the remedial purposes of those laws, *see, e.g., SEC v. Edwards*, 540 U.S. 389, 393 (2004)(securities with fixed rates of return qualify as investment contracts); *cf. SEC v. Zandford*, 535 U.S. 813 (2002)(interpreting the scope of the "in connection with" requirement for liability under S.E.C. Regulation 10b-5 and Section 10 of the 1934 Act).

Often, however, these judicial statements are actually *dicta* from decisions that decide narrow questions of statutory interpretation. For example, when the Supreme Court in *Edwards* resolved the specific question whether contracts with fixed rates of return qualified as "investment contracts" under the 1934 Act, it made reference to the remedial purpose of the statute and the need for a broad interpretation of the statutory term at issue in the case. Similarly, when the Court in *Zandford* specifically addressed the "in connection with" requirement of SEC Rule 10b-5, it again made reference to the remedial purpose of the securities laws and the need for a broad construction of the statutory language at issue.

It should also be noted, however, that the reach of the securities laws is not boundless. One line of demarcation limiting the reach of the securities laws is found in the CEA. While Congress painted with a broad brush in defining the sweep of the securities laws, Congress also painted with an equally broad brush when it expanded the definition of the term commodity in the Commodity Futures Trading Commission Act of 1974 and thereby drew a new line of demarcation between securities and commodity regulation.

This demarcation in law between securities and commodity regulation reflects real world differences in how securities and commodity markets are structured and operated. *See Securities and Futures: How the Markets Developed and How They Are Regulated* (GAO May 15, 1986)(securities markets facilitate capital formation; futures markets facilitate risk shifting and price discovery). In defining the scope of securities regulation, the Supreme Court has declared as a limiting principle that "Congress' purpose in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called." *Edwards*, at 393 (emphasis in original). Congress preserved this demarcation between investments and commodity trading when it acted in 1974.

Furthermore, it is important to note that the Supreme Court has emphasized that one of Congress' principal reasons for enacting the securities laws was the pressing need "to eliminate serious abuses in a largely *unregulated* securities market." *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 (1975)(emphasis added). But, here, the CME contract will be traded in a market that is subject to extensive federal regulatory oversight under the CEA, and so there is no danger that the CME contract would be unregulated at the federal level.

When dealing with fraudsters trying to evade legitimate regulatory oversight, courts understandably resort to *dicta* statements regarding the broad sweep of the securities laws in order to punish the instances of misconduct at issue before them. While such statements in isolation sound definitively clear and helpful, when they are compared and contrasted with the CEA's definition of a commodity and the remedial, customer-protection purposes embodied in commodity regulation, such *dicta* fail to inform the issue of the allocation of authority between regulators and self-regulators in the securities and commodity industries.

Finally, it should be noted that when the Supreme Court has considered transactions that are already subject to a system of financial services regulation, the Court has held that the contracts are not securities, on the reasoning that added regulation under the federal securities laws would be duplicative and unnecessary. *See Reves v. Ernst & Young*, 494 U.S. 56 (1990)(explicitly identifying existing regulation as a factor in determining whether a note can be excluded as short-term commercial paper); *Marine Bank v. Weaver*, 455 U.S. 551 (1982)(bank-issued certificate of deposit held not a security subject to federal securities laws since it is already federally insured and purchasers therefore do not need that extra layer of protection the laws afford); *Teamsters v. Daniel*, 439 U.S. 551 (1979)(interests in pension plan subject to regulation under ERISA held not to be securities). Therefore, the fact that

B. CME's Credit Event Contracts Are Based on Credit Default Swaps That Are Not Securities

In the alternative, while the CME contract does not purport to be an option to enter into the underlying swap, another reason its proposed contract should not be characterized as a security option is that its exchange-traded contract will derive its pay-out terms from the standard terms of a swap agreement, which is specifically excluded from the definition of a security by Title III of the Commodity Futures Modernization Act of 2000 ("CFMA").[11]

1. Credit Default Swap Agreements Are Not Securities

Entitled "Legal Certainty for Swap Agreements,"[12] CFMA Title III implements the swap agreement exclusion from SEC jurisdiction. CFMA Section 301 begins by establishing a definition of "swap agreement" in the form of Section 206A of the Gramm-Leach-Bliley Act of 1999 ("GLBA").[13] GLBA Sections 206A(a)(1) – (4) lists four categories of swap agreements and GLBA Section 206A(a)(5) provides that an option on any of four categories of swaps also is a swap agreement. CFMA Sections 302 and 303, in turn, amend the 1933 and the 1934 Acts to clarify the status of swaps. Thus, a new Section 2A has been added to the 1933 Act and a new Section 3A has been added to the 1934 Act stating that, for purposes of these statutes, a "security" does not include either a "security-based swap agreement" or a "non-security-based swap agreement," nor does it include an option on a swap. GLBA Section 206A(a)(2) expressly includes credit default swaps within the definition of swap agreement.

2. CME's Contracts Are Based On the Functional and Economic Equivalent of Credit Default Swap Agreements

CME's exchange-traded contracts will derive their pay-out terms from the standard terms of a credit default swap agreement. Credit default swaps that are individually negotiated and

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the CME's contract will be subject to regulatory oversight under the CEA should be a material consideration when a reviewing court decides whether added layer of regulation under the securities laws is appropriate.

[11] Appendix E of Pub. L. No. 106-554, 114 Stat. 2763 (2000).

[12] In the 1990s, the SEC claimed jurisdiction to regulate over-the-counter swap agreements on the theory that they were securities. *See* Willa E. Gibson, *Are Swap Agreements Securities or Futures? The Inadequacies of Applying the Traditional Regulatory Approach to OTC Derivatives Transactions*, 24 J.Corp.L. 379 (1999). *See also Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270 (S.D. Ohio 1996)(interest rate swaps). The cited provisions of the CFMA were enacted to end the legal uncertainty resulting from the SEC's jurisdictional claims over these over-the-counter contracts.

[13] The GLBA Section 206A(a) definition of a swap agreement includes a wide array of interest rate, currency, credit, equity, commodity, weather and other derivatives, provided that transactions are entered into by eligible contract participants and the material terms of the transaction (other than price and quantity) are subject to individual negotiation.

GLBA Section 206A(b) lists exclusions to the definition of the term swap agreement.

entered into between eligible contract participants ("ECPs") are excluded as securities on the basis of GLBA Section 206A(a)(2) and the amendments made to the definition of security in the 1933 and 1934 Acts by the CFMA. Although the underlying of CME's credit event contract is not individually negotiated or entered into between ECPs,[14] it is functionally and economically equivalent to a credit default swap because the contract's underlying derives its terms from a standard credit default swap agreement. The functional equivalence is further evidenced by the CME's having obtained copyright permission from ISDA in order to use these terms. *CME Submission* at 18 n. 1. While not a clear cut case, we believe that in light of this functional and economic equivalence, a court could reasonably conclude that the underlying on which the contract is based would be excluded from the definition of security by virtue of GLBA Section 206A(a)(2) and the securities laws amendments. Thus, the SEC should not be able to successfully assert jurisdiction under CEA Section 2(a)(1)(C)(i) or object to the CFTC's consideration or possible approval of the credit event contracts.[15]

C. <u>CME's Credit Event Contracts are Commodity Options</u>

Because CME's credit event contracts more likely than not are not options on securities excluded from the CEA under CEA Section 2(a)(1)(C)(i), they are options based solely on commodities in light of the CEA's broad definition of commodity in Section 1a(4) and the definition of "excluded commodity" in Section 1a(13).

The definition of commodity in Section 1a(4) includes "services, rights and interests." Courts have interpreted this definition broadly. *See generally Board of Trade*, 677 F.2d at 1142 ("[under section 1a(4)] *literally anything* other than onions could become a "commodity" and

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[14] In fact, there are no counterparties to the underlying of the CME's contract, whether ECP or retail, since the contract is not an option to enter into an underlying swap agreement

[15] While CFMA Title III excluded swap agreements from the SEC's jurisdiction, it also introduced a distinction between "security-based swap agreements" and "non-security-based swap agreements." These terms are defined in GLBA Sections 206B and 206C, respectively. A "security-based swap agreement" means a "swap agreement" of which a material term is based on the price, yield, value or volatility of any security or any group or index of securities, while a "non-security-based swap agreement" means any swap agreement that is not a security-based swap agreement.

Although not a "security" under the 1933 or the 1934 Acts, a security-based swap agreement is subject to a limited form of SEC authority. Specifically, Sections 302 and 303 provide that the anti-fraud, anti-manipulation, anti-insider trading, and short-swing trading provisions of the 1933 and 1934 Acts (including judicial precedents under those provisions) apply to the same extent that they apply to securities generally. The SEC is barred, however, from promulgating or enforcing rules or orders that impose reporting or recordkeeping requirements or otherwise regulate or require the registration of security-based swap agreements under either the 1933 or the 1934 Act.

To the extent that the ISDA credit default swap upon which the CME's contract is based lacks a security-specific delivery obligation, and contains nominal references to debt securities only as necessary in order to describe credit events, the swap is a non-security-based swap agreement under GLBA Section 206C since it does not include a material term based upon the price of a security. Accordingly, there appears to be no plausible basis for the SEC to assert even its limited authority on an argument that the underlying ISDA contract is a security-based swap agreement under GLBA Section 206B.

thereby subject to CFTC regulation simply by its futures being traded on some exchange.") (emphasis added); *accord American Board of Trade*, 803 F.2d at 1248 (finding that the "thrust of [the commodity] definition was expansive rather than limiting.").[16] Given this broad judicial construction of the definition, we believe that the credit risk events underlying CME's contracts would be found to qualify as commodities under Section 1a(4). Moreover, as explained above, the definition of "excluded commodity" expressly references "credit risk," and the underlying of CME's contracts comfortably falls within that definition.

Therefore, in light of the broad definition of the term commodity in CEA Section 1a(4) and the express reference to "credit risk" in the definition of excluded commodity in CEA Section 1a(13)(i), CME's contracts are options solely on commodities, which fall under the CFTC's exclusive jurisdiction.

IV. CBOE's and OCC's Arguments that CME's Credit Event Contracts are Options on Securities Are Not Persuasive

The CBOE and the OCC contend that the pay-out terms of the CME contract causes that contract to fall either within the definition of a security under the 1933 or the 1934 Acts. They also contend that, if the CME's event contract is considered an option on a swap agreement, the swap agreement does not satisfy the definition of swap agreement in the GLBA that qualifies for the exclusion from the definition of "security" under the securities laws. Neither of these arguments is persuasive.

A. CME's Credit Event Contracts Are Not Based on the Value of a Security

In arguing that CME's credit event contracts are options on securities, the CBOE cites the Court of Appeals for the Second Circuit's decision in *Caiola v. Citibank, N.A., New York*, 295 F.3d 312 (2d Cir. 2002). In *Caiola*, the court ruled that, although part of principal-to-principal transactions documented through standard ISDA swaps documentation, an over-the-counter cash-settled option was a security, rather than a swap, because the option was based on the value of a publicly-traded security. The court based its decision, in part, upon its interpretation of the statutory phrase "based on the value thereof" that is found in the definition of a security in Section 3(a)(10) the 1934 Act.[17] *Caiola* at 324-27. The CBOE draws upon the *Caiola* court's "value thereof" reasoning to premise its argument that the CME contract is a security option.

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[16] *See also United States v. Valencia*, a criminal action, in which defendant Valencia challenged the definition of commodity in the Act, arguing that the definition applies only to commodities that currently underlie exchange-traded futures or options contracts. The U.S. District Court for the Southern District of Texas rejected this argument. The court noted that while there is no futures contract on West Coast natural gas, the commodity at issue in the case, the determination of whether West Coast natural gas is "a commodity in which contracts for future delivery are presently or in the future dealt in," is a fact question, and that "there is no evidence that West Coast gas *could not in the future* be traded on a futures exchange." *United States v. Valencia*, No. H-03-024, Slip. Op. at 18, 2003 WL 23174749 at *8 (S.D. Tex. Aug. 26, 2003) (emphasis added), *rev'd on other grounds*, 394 F.3d 352 (5th Cir. 2004).

[17] Identically-worded statutory language is also found in phrases appearing in the definition of a security in Section 2(a)(1) of the 1933 Act, the exclusion for security options from the definition of swap agreement in GLBA Section 206A(b), and the grant of jurisdiction to the SEC over security options in CEA Section 2(a)(1)(C)(i).

CBOE Comment Letter at 4. The OCC joins the CBOE in this line of argument by stating that creditworthiness of an issuer of securities is "intimately related" to the value of that issuer's securities, particularly its debt securities. And so, the OCC argues, an option on an issuer's creditworthiness is, "in that essential economic sense," an option based upon the value of that issuer's securities. *OCC Comment Letter* at 1-2.

While we believe that the *Caiola* argument is the best argument available to the CBOE and the OCC, we agree with the CME that the "value thereof" argument misses the mark. *CME Comment Letter* at n. 8. For one thing, we question the extent of the CBOE's and OCC's reliance on *Caiola* since the court reached its decision on a narrow point of law by focusing on the specific issue whether the use of a cash-settlement delivery term rather than a physical-settlement delivery term altered the option's legal status for litigation purposes under Section 10(b) of the 1934 Act and SEC Rule 10b-5. The decision is also distinguishable, from a regulatory standpoint, insofar as *Caiola* addressed equity-based contracts that were publicly-traded in the securities markets rather than an event-based contract where a comparable means of public trading in event-based or even credit-based contracts through secondary markets is unavailable.

The *Caiola* decision is further distinguishable by the fact that it focused on over-the-counter options that were "analog" transactions whose value rose or fell as the value of the publicly-traded Philip Morris securities rose or fell. In *Caiola*, therefore, the over-the-counter contracts were specifically crafted to track, and to replicate, the price and price movements of a publicly-traded security. By contrast, the CME event contract is binary, with an all-or-nothing pay-out value that is not designed to move in tandem with the value of another contract or security.[18] The pay-out is triggered by certain credit events, and not by the price of any security. Thus, the contract is designed to track the rise and fall of the probability that the triggering credit events will or will not occur, not the fluctuations in price of any security. While changes in the price of the contract could be correlated with changes in the prices of the reference entity's securities if the market perceives a significant change in the probability of a credit default, at other times it is reasonable to expect that changes in the price of the contract and changes in the prices of the reference entity's securities would not be correlated, since non-credit-related factors would drive the price changes in the reference entity's securities. Therefore, the "economic reality"[19] of the credit event contract materially differs from the targeted "price-tracker"

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[18] The CME states that its contract will call neither for the delivery of an underlying security nor for the delivery of any measure of value of such a security. *CME Submission* at 1. Proposed CME Rule 45501 specifies that the event contract will be based solely upon named reference entities listed in the rule. *CME Submission* at 14. Credit events are further explained in the proposed Interpretations to Chapter 455. *CME Submission* at 16.

[19] In determining whether a transaction meets the statutory definition of a security under the federal securities laws, courts must look to the "economic reality" of the transaction under scrutiny. As the *Caiola* court observed:

> The Supreme Court has cautioned that in searching for the meaning and scope of the word 'security' ... the emphasis should be on economic reality. The definition of security is construed in a flexible manner, so as to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits. In this way, the economic reality approach permits the SEC and the courts sufficient flexibility to ensure that those who market investments are not able to escape the coverage of the Securities Acts by creating new instruments that would not be covered by a more determinate definition.

transaction in *Caiola*. We do not believe that the value of the CME's contract would move in a manner "sufficiently similar" to standardized options in order to be their economic equivalent. *See Stechler*, 382 F. Supp. 2d at 596-597 (granting, in part, motions to dismiss).[20]

While a nominal description of a reference entity necessarily includes a mention of the entity's obligations, the CME contract does not contain a "price-tracker" link that is tied to the numeric value of the price levels of the reference entity's securities. The absence of such a targeted, numeric-value-specific link demonstrates that the "intimate relationship" between the CME contract and the reference entity's securities, as argued by the OCC and the CBOE, lacks a basis in fact.[21] Thus, we believe that a court would consider such a missing "intimate" link as a material, and probably the dispositive, fact in the event of litigation.[22]

B. Even if the Underlying on Which The CME Event Contracts Are Based Does Not Meet the CFMA's Definition of Swap Agreement, It Does Not Follow That The Underlying is a Security

CBOE and OCC also contend that the CME's credit event contract is based on a swap agreement that is not excluded from the definition of a security under the securities laws. In this regard, they argue that the swap agreement on which the CME's contract is based is not individually negotiated, and is not entered into between ECPs, as required to meet the definition of swap agreement in GLBA Section 206A(a), because the CME contract is traded on exchange and may be offered to retail investors. As such, the swap agreement does not qualify for the

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Caiola at 325 (quotations and internal citations omitted).

[20] Implicit in the District Court's conclusion in *Stechler* was that, in addition to sufficient similarity, the underlying of an option must be a security within the definition of security in the securities laws (or an index of securities) in order for the option thereon to be considered a security. As noted above, however, the underlying of the CME's contract is not a security. In fact, the underlying here is a type of credit-enhancement contract currently offered as financial products by the banking, insurance, and surety industries. *See generally* Robert D. Aicher, Deborah L. Cotton, & T.K. Khan , *Credit Enhancement: Letters of Credit, Guaranties, Insurance and Swaps (The Clash of Cultures)*, 59 Bus. Law. 897 (May 2004)(analyzing the "commoditization" of letters of credit, insurance contracts, and credit default swaps, whereby the marketplace now treats each as substitutable for the others).

[21] In its surreply comment, CBOE contends that CME's contracts are based "on" a security within the definition of security, and that the definition does not require that the option result in physical delivery or be based on the value of a security. Further, CBOE argues that since CME's contracts references default events with respect to securities issued by the reference entity, the "economic reality" is that the contracts are based on securities. However, we believe CBOE's application of the Supreme Court's economic reality test is overly expansive. *Caiola* concludes that cash settled options are securities, applying the economic reality test, because they are based on the value of a security: there is some concrete linkage to a security. In *Stechler*, where the underlying for the options was a security index clearly within the definition of a security, the court nonetheless stated that in order to assess the economic reality of the options and make the determination that the options were securities, evidence would be required that would show that "the manner in which the "theoretical value" of a Digital Option fluctuates resembles the manner in which the value of a standard option fluctuates." 382 F. Supp. 2d at 597 (motion to dismiss). Thus, the courts have not adopted the expansive view of security under the economic reality test that CBOE advocates.

[22] Our analysis also comports with the general corporate law principle that distinguishes between a corporate entity, on the one hand, and the equity or the creditor interests in that entity, on the other.

exclusion from the definition of security in the securities laws. Therefore, they argue, the underlying swap agreement must be a security, and CME's event contract is an option thereon.

However, the CBOE's and OCC's argument fails. Even if the swap agreement on which the CME contract is based did not qualify for the exclusion from the definition of "security" contained in Section 2A of the 1933 Act and Section 3A of the 1934 Act, it does not follow that the swap agreement is a security. The swap agreement must itself meet the statutory definition of a security contained in Section 2(a)(1) of the 1933 Act and Section 3(a)(10) of the 1934 Act. Indeed, the CFMA includes a savings clause that provides that "[n]othing in this Act or the amendments made by this Act shall be construed as finding or implying that any swap agreement is or is not a security for any purpose under the securities laws." CFMA Section 304.[23] Thus, a swap agreement that does not qualify for the exclusion from the definition of security provided for in the CFMA amendments does not render that swap agreement a security. In any event, as noted above, the contract does not provide for the delivery of a security, nor is it based on the value of a security.

Conclusion

For the reasons discussed above, the CFTC has exclusive jurisdiction over the CME's proposed credit event contracts under CEA Sections 2(a)(1) and 4c(b), and it would be acting within the scope of its statutory authority if it determines to approve these contracts for trading on the CME, provided that the contracts do not otherwise violate the CEA.

[23] Although the savings clause also states that "[n]othing in this Act or the amendments made by this Act shall be construed as finding or implying that any swap agreement is or is not a futures contract or commodity option for any purpose under the Commodity Exchange Act," the issue here is whether the *underlying* is a security or a commodity, not that the underlying is a security or a futures contract (or commodity option). Accordingly, this provision of the savings clause is inapplicable.

U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5260
Facsimile: (202) 418-5527
www.cftc.gov

Division of
Market Oversight

January 26, 2007

MEMORANDUM

TO: The Commission

FROM: The Division of Market Oversight

SUBJECT: Request for Commission Approval of the Chicago Mercantile Exchange's Credit Event Futures contracts, based on Centex Corporation, Jones Apparel Group, Inc. and Tribune Corporation; submitted pursuant to Section 5c(c)(2) of the Commodity Exchange Act and Commission Regulation 40.3.

CONCLUSION AND RECOMMENDATION: The proposed contracts appear to comply with the requirements of the Commodity Exchange Act and the Commission's regulations and policies thereunder and are complete under the Commission's approval process. Accordingly, the Division of Market Oversight recommends that the Commission approve the proposed CME contracts, and the associated new rules, pursuant to Section 5c(c)(3) of the Commodity Exchange Act. The Division further recommends that the Commission inform the CME that it considers the proposed contracts to be solely commodity option contracts and that CME should treat the contracts accordingly.

STAFF CONTACTS:

Rose Troia	202-418-5271
Thomas Leahy	202-418-5278
Bruce Fekrat	202-418-5578
David Van Wagner	202-418-548[illegible]

CONCURRING: Office of the Chief Economist
Office of the General Counsel

I. INTRODUCTION

In correspondence dated October 17, 2006,[1] and October 24, 2006, the Chicago Mercantile Exchange (CME or Exchange) voluntarily requested Commodity Futures Trading Commission (Commission or CFTC) review and approval of *Credit Event Futures*[2] (Credit Event) contracts, based upon three reference entities – Centex Corporation, Jones Apparel Group, Inc., and Tribune Corporation.[3] The approval request was made pursuant to Section 5c(c)(2) of the Commodity Exchange Act (CEA or Act) and Commission Regulation 40.3.

In accordance with Section 2(a)(9)(B)(i) of the Act, the Division forwarded to the Securities and Exchange Commission (SEC) the initial proposed new contract filing on October 18, 2006 and the subsequent filing on October 24, 2006. Both contract filings were forwarded also to the U.S. Department of Treasury (Treasury) and the Board of Governors of the Federal Reserve System (Fed) on November 8, 2006. No written comments were received from those agencies.[4] The Commission posted all of the filings on its website with a request for public comment and received six responsive comments from three commenters. All of those comments are summarized in the last section of this memorandum.

Subsequent to the comment period, the CME, pursuant to the request of the Commission, amended the terms and conditions of its contracts in filings dated January 12, 2007 and January 16, 2007.[5] Those amendments limited the list of credit events to bankruptcy and amended the

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[1] With the original submission dated October 17, 2006, the CME requested confidential treatment of the filing. On October 18, 2006, CME withdrew that request for confidentiality, based upon conversations with Commission staff.

[2] The CME refers to the subject contracts as futures contracts. However, as discussed below, in view of the characteristics of these contracts, the Division of Market Oversight (Division) believes the subject contracts are binary options.

[3] In a filing dated October 24, 2006, the CME changed the underlying reference entity for one of the subject contracts, to Centex Corporation from Cendant Corporation.

[4] The Division notes that Commission staff did consult with SEC staff during the pendency of the approval process. This Memorandum, however, solely reflects the opinion of the Division.

[5] The amendments to the CME Credit Event Futures contracts were posted on the Commission's website on January 16 and 17, 2007.

definition of bankruptcy that the CME intends to use.[6] Those filings were forwarded to the SEC, the Treasury, and the Fed on January 16, 2007 and January 17, 2007.

The 45-day Fast-Track review period for the CME's proposal, under Commission Regulation 40.5, was scheduled to end on December 1, 2006. On November 29, 2006, however, the Director of the Division of Market Oversight, acting pursuant to authority delegated in Commission Regulation 40.7(a)(1), extended the review period by 45 days.[7] The extended Fast-Track review period for the CME's proposal, as well as the statutory review period,[8] was scheduled to end on January 16, 2007. However, in the CME's amendment filing dated January 12, 2007, the CME agreed to a 15-day extension of the Commission's review period to January 31, 2007.

II. BACKGROUND

A credit derivative may be defined as "a derivative designed to assume or shift credit risk, that is, the risk" that a particular borrower will experience an event included within a specific set of credit events, such as loan defaults or bankruptcy filings, within a specified interval of time.[9] Credit derivatives emerged in the mid-1990s as bilateral OTC instruments that allow one party (the protection buyer) to transfer credit-related risks associated with the actual or synthetic ownership of a "reference asset" to another party (the protection seller) for a price.[10] The

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[6] Those filings also made several non-substantive amendments to the contract terms and conditions. The terms and conditions of the proposed CME Credit Event contracts are attached to this Memorandum. The various CME filings are available upon request from the Secretariat or the Division.

[7] Commission Regulation 40.3(c) allows the Commission to extend the 45-day Fast-Track review period by an additional 45 days if the product raises novel or complex issues requiring additional time for review.

[8] Section 5c(c)(2)(c) of the Act provides that the Commission "shall take final action" on contracts submitted for approval no later than ninety days after submission of the contract, unless the contract market submitting the contract agrees to an extension of the review period.

[9] *See, e.g.*, CFTC Glossary *available at* (http://www.cftc.gov/opa/glossary/opaglossary_a.htm.)

[10] In the OTC market, the terminology "protection seller" and "protection buyer" is used to refer to the seller and buyer of a credit derivative.

reference asset associated with an OTC credit derivative may be a corporate debt obligation, such as a bond or a bank loan, a sovereign debt obligation, an asset-backed security, such as commercial mortgage-backed securities, or any other obligation of debt. Credit derivatives transfer only the credit risks attendant to the actual or synthetic ownership of a reference debt obligation. Other important risk factors, such as interest rate risk, are not transferred by the derivative, and therefore remain with the obligation's owner.

The simplest and most common credit derivative product in the OTC market is the "credit default swap" (CDS). Under a CDS, the protection seller promises to compensate the protection buyer for the economic loss associated with a material decline in the value of a "reference asset" that is triggered by the occurrence of a pre-determined "credit event," such as a filing for bankruptcy, which the reference entity's issuer can experience. In some CDS contracts, the protection buyer pays the protection seller a "periodic premium"[11] for the protection. Premium payments are usually made quarterly in arrears. A CDS contract typically specifies that a credit event be pegged to an obligor's performance on a reference obligation, such as a bond or a loan. If a requisite credit event occurs, then the protection buyer would receive a full lump-sum payment that is some fraction of the par value of the reference asset, to compensate the buyer for the asset's devaluation. In turn, the protection buyer would deliver the devalued asset to the protection seller.

In the OTC market, a CDS is quoted in basis points, and each quote typically is a firm quote for a minimum notional value of $10 million. CDS pricing is based on the probability that the reference entity will experience a credit event and the expected recovery rate. The expected recovery rate is the fractional amount of par value that the protection seller can expect to recover

[11] The term periodic premium refers to a series of payments made at set intervals on specified dates. The first premium payment is made at the time the CDS is entered into. Typically, the payment dates coincide with the cash flows generated by the underlying instrument.

upon taking possession and liquidating the devalued asset.[12] The recovery rate is often defined as a percentage of the face value of the reference asset.

The following example is illustrative of the material characteristics of a simple CDS. Assume that an institutional investor owns $10 million worth of Corporation Q's debt, which matures in five years. To manage the risk of loss if Corporation Q were to default on this debt sometime before the date of maturity, the investor buys a CDS from a bank in the notional amount of $10 million. In return for the credit protection provided by the bank, the investor agrees to pay to the bank an annual premium of 1% of $10 million ($100,000), in periodic installments of $25,000 each quarter. If Corporation Q does not default on its bond payments, the investor continues to make the quarterly payments over the five years. At the end of the five-year period, the protection buyer would receive back from Corporation Q the $10 million the investor had paid for the debt instrument. In contrast, for example, if Corporation Q defaults on its debt after two years, then the investor would cease making further premium payments and, at the time of the default, would collect the $10 million protection amount from the bank. In exchange, the bank would receive the (devalued) debt instrument from the investor. By entering into the credit derivative swap, the investor has hedged its risk of loss associated with a credit event on Corporation Q's debt.

Credit events are defined in Article IV of the 2003 International Swaps & Derivatives Association's (ISDA) *Credit Derivatives Definitions*. These definitions and standards are well established, and they have been adopted for widespread use in the OTC market. Under these definitions and standards, a "credit event" includes the bankruptcy of a reference entity, as well as the following: a reference entity's failure to pay on a debt obligation; the repudiation of a debt

[12] *See* Hull, J. C. and A. White, *Valuing Credit Default Swaps I: No Counterparty Default Risk*, Journal of Derivatives, vol. 8, no. 1 (Fall 2000); *see also*, Hull, J.C. and A. White, *The Valuation of Credit Default Swap Options*, (Jan. 2003).

obligation; a moratorium placed on a debt obligation; the acceleration of the payment terms of a debt obligation; a default on a debt obligation; and restructuring the terms of a debt obligation. Generally, bankruptcy, along with failure to pay and restructuring, is considered to be among the three most important trigger events for settling a CDS.[13]

Credit derivatives represent the fastest growing segment of the OTC derivatives market. The notional amount outstanding in global credit derivatives markets increased from US$180 billion in 1997 to US$5 trillion in 2004, and it is expected to rise to US$33 trillion by end of 2008.[14] The outstanding notional value of this segment of the industry grew by 52% over the first six months of 2006, to a notional value of approximately US$26 trillion from a notional value of approximately US$17.1 trillion at the end of 2005.[15] Over the first six months of 2006, nearly half the notional amount outstanding (approximately US$12 trillion) in the credit derivative market were CDS transactions. Banks (51%) – mainly investment banks – are by far the largest participants in the OTC credit derivative market, followed by securities firms (18%), hedge funds (16%), insurance companies (7%), corporations (3%), pension funds (3%), mutual funds (3%) and governments (1%).[16]

III. CME's CREDIT EVENT CONTRACTS

A. General Description

The proposed CME Credit Event contracts are binary event contracts that have a payoff structure of either zero or a fixed positive amount if the reference entity experiences bankruptcy. For the proposed contracts, CME defines bankruptcy as:

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[13] *See A Debate on Exchange Traded Credit Default Swaps*, August 15, 2006, *available at* (http://www.gtnews.com/article/6439.cfm) (free registration required).

[14] *See British Bankers' Association (BBA) Credit Derivatives Report*, 2006, *available at* (http:// http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=145&a=7672).

[15] *See* ISDA's News Release, September 19, 2006, *available at* (http://www.isda.org/press/press091906.html).

[16] *See BBA Credit Derivatives Report*, 2003/2004.

(1) a voluntary petition by the Reference Entity that has not been dismissed by the expiration date of the Contract; or (2) an involuntary petition against the Reference Entity with respect to which an order of relief has been issued by the Court prior to the expiration date of the Contract (irrespective of whether such order of relief is subsequently reversed on appeal, nullified, vacated, dismissed or otherwise modified after the expiration date of the Contract).

When a position is established, the long position holder pays a premium to the short position holder. If the reference entity experiences a bankruptcy at any time prior to the contract's expiration, then a cash payment is made by the short position holder to the long contract holder. The amount of the cash payment would be equal to the Final Settlement Rate (F) multiplied by the Notional Value, both of which are established by the Exchange upon listing of a contract.[17] If the reference entity does not experience the specified credit event prior to the contract's expiration date, then the contract would expire worthless. If the contract expires worthless, the short position holder retains the original premium paid by the long position holder.

The CME Credit Event contracts are similar to the "fixed recovery CDSs" in the OTC market with two differences. First, in an OTC CDS, there is a physical exchange of the instrument, or a reference to the asset's price, if a credit event occurs (as noted in the above example of a typical credit derivative swap). There would be no such exchange with respect to the CME contracts. Secondly, unlike a fixed recovery OTC CDS, pricing for the CME contracts would not depend on the underlying reference asset's price. Instead, the pricing of the CME contracts would be based on the known fixed payment that would be made if a credit event occurs. The proposed contract would mimic periodic premiums in the OTC market by using futures accounting practices of initial and maintenance margin to draw down this fixed payment over time. That is, the proposed contracts would require an initial performance margin deposit that then would be marked-to-market on a daily basis. Thus, as the expiration date of a CME Credit Event contract draws near, the entire value of the protection would have been paid from the

[17] The Exchange may offer several contracts with different combinations of Notional Values (*e.g.*, $50,000, $100,000, $200,000, etc.) and Final Settlement Rates (*e.g.*, F=40%, 50%, 60%, etc.) based on the same reference entity.

long to the short through the mark-to-market process. If a CME-defined credit event occurs prior to the expiration date, then the Credit Event contract would terminate early and the short position would be marked-to-market based on the final settlement amount (that is, the notional value times the final settlement rate).

B. The CME Credit Event Contracts

As noted, the Exchange proposed CME Credit Event contracts based upon three reference entities: Centex Corp., Jones Apparel Group, Inc., and Tribune Corporation.[18] According to the CME, those companies were selected in part based on their credit ratings and credit spreads. Currently, the reference entities' long-term debt is investment grade or just below investment grade, and is classified as medium- to high-risk.[19] Credit ratings are used to establish credit spreads for the relative default or non-payment risk associated with corporate debt instruments. Credit spreads are a function of both credit rating and time to maturity.[20] The three CME Credit Event contracts also were selected based on activity and pricing in the OTC CDS market. Currently, the subject reference entities underlie some of the most active credit-default swap contracts traded in the OTC market.

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[18] Centex Corporation, through its subsidiaries, builds homes, originates retail mortgages, acts as a general building contractor, offers pest control services, and retails building supplies. Tribune Company conducts operations in publishing, television, radio stations, and interactive ventures. Tribune Company publishes newspapers that include the "Chicago Tribune," "The Los Angeles Times," and "Newsday." It also offers a variety of local and national news and information web sites. Jones Apparel Group, Inc. designs and markets a variety of apparel, including sportswear, jeans wear, suits, dresses, and footwear. Its brand names include Jones New York, Evan-Picone, Nine West, Bandolino, Norton McNaughton, Ralph Lauren, and Polo Jeans Company.

[19] According to Bloomberg, as of October 26, 2006, Centex Corporation, Tribune Corporation and Jones Apparel have credit ratings of BBB (for 15 corporate security issues), BB+ (for 7 corporate security issues), and BBB- (for 3 corporate security issues), respectively. Debt that is rated BBB- or higher is considered investment grade debt; debt rated BB+ or lower is considered to be non-investment grade debt. Non-investment grade bonds are often referred to as high yield bonds. Lower rated high yield bonds are often referred to as junk bonds. U.S. Treasury securities are generally viewed as the U.S. dollar benchmark for default-free or risk-free fixed income securities. U.S. Treasury securities will always imply an element of market risk associated with interest rate fluctuations but they are viewed as implying zero credit risk.

[20] Borrowers typically demand a higher credit spread premium as the term to maturity of a corporate bond increases due to the higher probability of credit default over the longer time horizon.

The proposed CME Credit Event contracts would be based on a fixed payout of $100,000 notional value times a specified Final Settlement Rate of 50%. Thus, if the reference entity experiences a bankruptcy, the Final Settlement Price would be $50,000 (50% of $100,000). Because of the binary nature of the proposed contracts, the contract price would reflect the market's perception of the expected probability that a bankruptcy would occur. For example, suppose the CME listed a Credit Event contract on XYZ Corporation and the Notional Value and Final Settlement Rate were set at $100,000 and 50%, respectively. Suppose the market initially perceives that the probability of bankruptcy at any time during the next five years is 8%. Because the contract would pay $50,000 if a bankruptcy occurs prior to expiration, or otherwise expire worthless, the price of the contract would be $4,000.[21] Subsequently, suppose that the corporation's financial condition deteriorates so that the market's perception of the probability of bankruptcy occurring during the remaining life of the contract increases to 30%. The contract price would increase because the new expected value of the contract would be $15,000.[22]

C. Economic Purpose and Benefits of Hedging

The CME noted that Credit Event contracts can help to alleviate the effects of price risk in the long-term capital markets through capital efficiencies. Specifically, the CME intends for its Credit Event contracts to provide a transparent, liquid and easy means of acquiring protection against the risk of bankruptcy. In addition, the CME noted that its Credit Event contracts would introduce the benefits of exchange-traded products to the credit derivatives industry where all trading currently is conducted OTC. Moreover, because the proposed contracts would be cleared and guaranteed by the CME Clearing House, institutions could cross-margin a CME Credit Event

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[21] The contract price would equal the expected value of the contract. Specifically, if there is an 8% chance that the short would be obligated to pay to the long $50,000 and a 92% chance that the contract would expire worthless, then the contract price would be 0.08 * $50,000 + 0.92 * $0 = $4,000.

[22] Specifically, the contract price would be 0.30 * $50,000 + 0.70 * $0 = $15,000.

contract against other CME Credit Event contracts or against interest rate futures contracts cleared by the CME.

The CME Credit Event contracts could provide hedging benefits for holders of the reference entity's debt securities in case of a bankruptcy by the reference entity. The long would be able to "lock in" the cost to protect an investment in a reference entity's bonds or other instruments by paying a premium to the short.

IV. COMPLIANCE WITH THE ACT AND COMMISSION REGULATIONS

As noted, the CME requested approval pursuant to section 5c(c)(2) of the Act and Commission Regulation 40.3. Section 5c(c)(3) of the Act requires the Commission to "approve any such new contract or instrument ... unless the Commission finds that the new contract or instrument...would violate this Act."

The proposed Credit Event contracts appear to meet the requirements of the Commodity Exchange Act, including Core Principles 3 and 5 and the acceptable practices for these core principles including Commission Guideline No. 1 and all other applicable Commission policies. Core Principle 3 states that a "board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation." The Acceptable Practices for Core Principle 3 state that Guideline No. 1 (Appendix A under Part 40 of the Commission's regulations) may be used to determine whether the proposed contracts satisfy this requirement. As discussed below, it appears that the terms and conditions of the Credit Event contracts meet the standards for cash settled contracts in Guideline No. 1.

Terms and Conditions of the Proposed CME Credit Event Binary Contracts

Term	Exchange Proposal	Comment/Analysis
Unit of Trading/Commodity Specification	The occurrence of a bankruptcy.	Acceptable for hedging credit risk associated with the reference entity.

Term	Exchange Proposal	Comment/Analysis
Exercise Style	European. If a credit event occurred, then the expiration date would be accelerated to the date on which the credit event is confirmed.	Acceptable. A European style option can be exercised only at expiration.
Contract Size	$50,000 per binary option. The final settlement value if a credit event occurred would be equal to the notional value, set initially at $100,000 per contract, times the final settlement rate (F), set initially at (50%). For each contract, the notional value and final settlement rate are fixed at initial listing and may not vary through expiration. The notional value and final settlement rate may differ across contracts, but are fixed for each contract.	Acceptable. Although smaller than typical institutional transactions in securities and credit derivatives, the smaller contract size would enable hedgers to more precisely hedge their exposure to the risk of bankruptcy by the reference entity. There are no impediments to settlement given the cash settlement provision.
Cash Settlement Procedure	Settlement would be binary in nature. The occurrence of a credit event must be confirmed by the Exchange. Early expiration and settlement would be triggered if a bankruptcy occurs prior to expiration. The contract would expire worthless if no credit event occurred before expiration.	Acceptable. The cash settlement price is reliable, acceptable, publicly available, and timely (see table below).
Pricing Basis and Minimum Tick *(Checklist Item 6)*	The price would reflect the probability that the reference entity will experience a credit event, i.e., bankruptcy, at any time prior to expiration. Pricing would be quoted in basis points (bp), in increments 0.5 bp per contract. Based on a notional value of $100,000, the value of the minimum tick would equal $5.00 per contract.	Acceptable. The binary option price is a measure of the probability that the binary option will expire in the money. There is no cash market for credit events per se. Thus, the minimum tick is a business decision of the Exchange.
Speculative Position Limit *(Checklist Item 1)*	5,000 contracts in all contract months combined.	Acceptable. Because there is no cash market for the underlying credit events no position limit is required. Therefore, the CME speculative position limit provision is more conservative than necessary.
Aggregation Rule *(Checklist Item 2)*	Same as CFTC Rule 150.5(g).	Consistent with Guideline No. 1 standard and therefore acceptable.
Reporting Level *(Checklist Item 3)*	25 contracts.	Acceptable. Equal to the reporting level specified in Commission Regulation 15.03.
Strike Condition *(Checklist Item 4)*	The occurrence of a credit event, defined as a bankruptcy experienced by the reference entity.	Acceptable. The strike condition is specified and automatic.

Term	Exchange Proposal	Comment/Analysis
Last Trading Day *(Checklist Item 5)*	Trading terminates at 12:00 noon on the second London business day before the third Wednesday of the contract month. If a credit event is declared, then trading would terminate at the end of the trading day on that day.	Acceptable. It is reasonable to end trading on the day that a credit event is declared since the contract's final settlement value would be known.
Trading/Expiration Month	Contract months of June and December listed five (5) years in the future.	Any expiration month would be acceptable from an economic standpoint.
Trading Hours (Chicago Time)	Offered exclusively on the CME Globex® electronic trading platform Sundays through Thursdays from 5:00 p.m. to 4:00 p.m. the following day. Daily shutdown from 4:00 p.m. to 5:00 p.m.	Any hours are acceptable.
Automatic Exercise Provision	Binary event options would be automatically exercised if the reference entity experienced a credit event.	Acceptable.
Price Limit/Premium Fluctuation Limits *(Checklist Item 7)*	None.	Acceptable.

Commission Guideline No. 1 Requirements for Cash Settlement Price Series

	Comment/Analysis
Not readily susceptible to manipulation.	For the proposed contracts, CME defines bankruptcy as: (1) a voluntary petition by the Reference Entity that has not been dismissed by the expiration date of the Contract; or (2) an involuntary petition against the Reference Entity with respect to which an order of relief has been issued by the Court prior to the expiration date of the Contract (irrespective of whether such order of relief is subsequently reversed on appeal, nullified, vacated, dismissed or otherwise modified after the expiration date of the Contract). A bankruptcy event triggering cash settlement of the proposed contracts would not be readily susceptible to manipulation or distortion for several reasons: • The information required to determine whether such a credit event had occurred relates to actions by an independent third party, the corporation referenced for each particular contract or a U.S. Bankruptcy Court. • There is no underlying cash market *per se*, so the contracts would not rely upon any cash price series or cash market activity for purposes of determining whether a contract is to be exercised or the amount of the cash settlement payoff. • The specified credit event typically is not within the control of any person. • A bankruptcy must be confirmed by the Exchange.

	Comment/Analysis
Reflective of underlying cash market.	Acceptable. There is no underlying cash market per se. The CME must confirm that a bankruptcy has occurred. Information to make such a confirmation is publicly available. Therefore, the declaration of a credit event is reflective of corporate events related to bankruptcy of the reference entity.
Reliable indicator of cash market and acceptable for hedging.	Acceptable. There is no underlying cash market per se. As noted, the Exchange must confirm whether a credit event has occurred based on public sources of information. Therefore, a credit event announcement by the Exchange is a reliable indicator that a bankruptcy has occurred, and thus the proposed contracts are acceptable for hedging credit risk associated with bankruptcy of the reference entity.
Publicly available and disseminated on a timely basis.	Information used for confirmation of a credit event typically is made through several public sources, including, U.S. Bankruptcy Courts and major financial news media. The CME will announce on its website when a credit event has occurred, and that information also will be readily available from public sources on a timely basis. Therefore, the CME Credit Event contract appears to meet the public availability and timeliness requirements.

V. SUMMARY OF COMMENTS AND STAFF EVALUATION

A. Overview

The CME, the Chicago Board Options Exchange (CBOE), and the Options Clearing Corporation (OCC) comment letters all focus on the issue of whether the CME Credit Event contracts are properly subject to CFTC jurisdiction. The CBOE and OCC argue that the products are option contracts on securities and, therefore, are securities outside of the CFTC's jurisdiction and improper for listing on the CME. The CME contends the contracts are futures contracts on commodities that are not securities and, therefore, are within the CFTC's jurisdiction and appropriate for CFTC approval.[23]

[23] As noted above, the CME modified the terms of its proposed Credit Event contracts during the pendency of its filing upon the request of the Commission. The originally-proposed contract included six triggering credit events, including the bankruptcy of the contract's Reference Entity. CME modified its contract by refining the details of the bankruptcy trigger event and deleting the other five non-bankruptcy trigger events. The CBOE, OCC and CME comments summarized and addressed herein were all submitted to the Commission prior to CME's modification of its contract. The Division notes, however, that none of the comments seem to have been premised on particular underlying credit events. Accordingly, the Division, in reviewing the comments, has generally presumed that they would apply with equal force to the current version of the contract that is based solely on a bankruptcy credit event.

B. CBOE and OCC Comments – The CME Products are Options

As previously discussed, the CBOE and OCC both contend that the CME's proposed contracts are option contracts and not futures contracts. They generally note that option contracts require purchasers to pay a premium and expose purchasers to limited risk (the possible loss of the premium paid). Although the premium paid will not be recovered if there is an adverse price movement in the underlying asset, option purchasers have no further legal obligation with respect to contract performance while the obligation of option sellers to perform under the terms of the contract remains until exercise or expiration.

The CBOE and OCC observe that this non-linear, asymmetric character distinguishes a forward or futures contract – the terms of which require both parties to perform routinely and to face the full risk of loss from adverse price changes – from an option contract. The CBOE and OCC contend that the seller of a CME Credit Event contract would be the only party bearing the risk of a credit event occurring in return for a non-refundable premium. They assert that, while this premium would be paid over time through the margin process, such an approach can not make a contract a futures contract. The CBOE emphasizes that under existing margin rules of the securities exchanges, securities customers are permitted to purchase long-term options, including stock and index options, on margin.

C. CBOE and OCC Comments – The CME Contracts are Securities

The CBOE and OCC both conclude that the CME Credit Event contracts are options that are securities. The OCC makes a single and relatively straightforward argument. The OCC argues that the CME contracts are based upon the creditworthiness of an issuer of securities. They observe that the creditworthiness of an issuer of securities is closely linked to the value of its debt securities. Thus, according to the OCC, the CME Credit Event contracts should be considered to be option contracts that are securities.

The CBOE's arguments are more nuanced and varied, with many of its points developed in the course of responding to the CME's comments (which in turn largely respond to the CBOE's comments). A number of the CBOE's arguments are premised on the contention that the value of the CME Credit Event contracts are "based on the value" of securities. The term security is defined in the Securities Act of 1933 ('33 Act) and the Securities Exchange Act of 1934 ('34 Act)[24] and incorporated by reference by the provision in the CEA that excludes securities options from the Commission's jurisdiction.[25]

At the outset, the CBOE cites case law to emphasize that cash-settled options based on features of specified securities other than a security's common price are within the statutory definition of the term security.[26] The CBOE then argues that the price of the CME's Credit Event contracts will fluctuate with the market's perception of the likelihood that a Reference Entity will experience a credit event during the term of the contract. So, for instance, if a Reference Entity files for bankruptcy, the value of the Reference Entity's securities and the price of the relevant Credit Event contract will be both directly and materially affected. Thus, the CBOE concludes that the correlation between the price of a Credit Event contract and the price of a reference

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[24] Section 2(a)(1) of the '33 Act defines security to mean:

> . . . any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. *See also* Section 3(a)(10) of the '34 Act.

[25] CEA Section 2(a)(1)(C)(i) excludes from Commission jurisdiction " . . . any transaction whereby any party to such transaction acquires any put, call, or other option on one or more securities (as defined in . . . section 3(a)(10) of the Securities Exchange Act of 1934 . . .), including any group or index of such securities, or any interest therein or based on the value thereof."

[26] *See Caiolo v. Citibank*, 295 F.3d 312 (2d Cir. 2002).

entity's securities following a credit event (*i.e.*, bankruptcy) is evidence that the CME Credit Event contracts are based on one or more securities or an interest therein or the value thereof.

In further support of its argument, the CBOE argues that certain underlying credit events can be defined in a manner that links them directly or indirectly to a particular Reference Entity's debt securities. The CBOE contends that credit events, such as defaults, can be linked to the terms of specific debt securities and therefore are option contracts based on securities. For example, the CBOE states that settlement on the CME's Credit Event contracts is based on a "Final Settlement Rate" that can be linked to the notional value of a Reference Entity's debt securities. The CBOE concludes that the Final Settlement Rate is, therefore, the equivalent of an estimated recovery rate of an underlying security issued by a Reference Entity.

The CBOE, without precision and in a conclusory manner, alternatively suggests that the CME Credit Event contracts can be viewed as contracts based on a swap that is not excluded from the definition of a "security" under the amendments introduced by the CFMA to the Gramm-Leach-Bliley Act of 1999 (GLB).[27] In support, the CBOE notes that the exclusion for CDSs from the definition of security applies only to swaps that satisfy certain specified criteria, including the requirement that they be individually negotiated and entered into solely by eligible contract participants. The CBOE seemingly concludes that since trading in the CME Credit Event contracts would not meet these criteria, the contracts would necessarily be non-excluded swaps that are securities.

D. CME Comments – The CME Products are Futures Contracts

The CME contends that its Credit Event contracts are cash-settled index futures contracts, based on a digital index, rather than options. The CME argues that its contracts lack certain features characteristic of options. For instance, the risk structure of a CME Credit Event contract implies a bounded risk and a bounded profit potential on the part of both the long and short,

[27] *See* GLB Section 206A and CFMA Sections 302 and 303.

unlike options which do not normally limit the purchaser's profit potential or the seller's risk. The CME further notes that buyers of Credit Event contracts would not enjoy any optionality given that, if a credit event occurs, the short must make a payment and the long would not have the ability to override that automatic payment. In contrast, the CME points out that the buyer of a traditional option contract ordinarily has the right, but not the obligation, to exercise the contract.

E. CME Comments – The CME Contracts are Not Securities

The CME asserts that its proposed Credit Event contracts are not based on any security or securities, or the value of any security or securities, issued by a Reference Entity. The CME points out that the seller of a Credit Event contract will not undertake an obligation to deliver a security or to make a payment based on the value of a single security or some basket of securities. Similarly, the CME points out that the purchaser of a contract will not acquire an ownership interest in the underlying corporation or any of the corporation's securities. The CME argues that there is nothing in the definition of a security in the '33 or '34 Acts which corresponds to the interest represented by the proposed contract, and that, moreover, the interest represented by the contract is not based on the value of a security and meets none of the judicial tests regarding an investment in a common enterprise.[28]

The CME dismisses the various CBOE and OCC arguments that the relationship between the Credit Event contracts and the securities of a Reference Entity is sufficient to render the Credit Event contracts securities. The CME contends that the CEA more narrowly prohibits DCMs from listing options based on the value of securities, not from listing options "whose value may depend on corporate events or economic events that directly impact companies."

The CME also notes that the Final Settlement Rate is not a recovery rate that is tied to the pricing of the securities of any Reference Entity. The CME emphasizes that the payment at

[28] *See SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

settlement is fixed and known to the parties prior to entering into the contract. The CME also notes that, even if a credit event was defined by a general reference to defaults on the securities issued by a Reference Entity, the value of the contract would be established by perceptions respecting the likelihood of a credit event occurring and the payoff that is fixed in advance of trading, without any reference to any "recovery rate" of any security.[29]

The CME goes on to assert that CME Credit Event contacts are distinct from CDSs traded in the OTC market only in that OTC contracts are negotiated bilaterally. The CME observes that similarly structured transactions are presently excluded from the definition of a "security" under the CFMA when traded OTC. The CME suggests that, if the CME cash settled Credit Event contracts were traded OTC, with terms that were subject to individual negotiation, they would be classified as non-security-based swap agreements excluded from the definition of security under Section 206C of GLB.[30] The CME concludes that publicly trading, on the facilities of a designated contract market, an instrument having the same value and payment characteristics as a transaction that is specifically excluded from the definition of security can not convert the instrument into a security.

Whether traded OTC or on an exchange, according to the CME, Credit Event contracts have none of the material characteristics of securities. Rather, the proposed contracts provide a hedging mechanism for lenders and others that have commercial ties with Reference Entities and would be affected adversely by credit events. According to the CME, credit event options in general and the CME Credit Event contracts in particular, are cash settled contracts with values dependent only upon the occurrence or non-occurrence of defined credit events respecting an

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[29] The CME stated in its second comment letter that the reference to "recovery rate" in its initial filing was part of a general discussion of credit default swaps included in the filing pursuant to Commission Regulation 40.3(a).

[30] *See* GLBA Sections 206A, 206B and 206C.

underlying Reference Entity and not directly based on the price or value of corporate debt securities or interests therein.

F. Staff Evaluation of Comments and Commission Jurisdiction

1. Overview

The above comments essentially analyze two queries. First, are the CME Credit Event contracts option contracts or futures contracts? Second, are the CME Credit Event contracts based on the value of a security per the requirements of the '33 and '34 Acts? The answers to these questions could lead to four different outcomes. First, if the contracts are futures contracts based on a commodity that is not a security, then they are subject to the exclusive jurisdiction of the CFTC under CEA Section 2(a)(1)(A). Second, if they are futures contracts based on a security, then they are securities futures products subject to joint regulation by the CFTC and the SEC under CEA Section 2(a)(1)(D). Third, if the CME Credit Event contracts are options on commodities that are not securities, then they are subject to the exclusive jurisdiction of the CFTC under CEA Sections 2(a)(1)(A) and 4c(b). Fourth, and in contrast to the third outcome, if the CME Credit Event contracts are options on securities, or based on the value of securities, then they are subject to the securities laws and excluded from the CEA.

2. The CME Credit Event Contracts are Option Contracts

Based on legal precedent and economic analysis, the CME contends that its contracts are futures contracts. Based upon the same legal foundation and facts, the CBOE and OCC contend that the CME contracts are options. Staff is in agreement with the CBOE and the OCC.

The Commission regulates transactions that involve commodities, and are commonly known to the trade as options.[31] Staff also notes that options with similar characteristics and payout features have been recognized by the Commission to be option variants commonly known

[31] *See* Section 4c(b) of the Act.

as binary options.[32] Binary options, like the CME Credit Event contracts, can provide for a payment of a premium by the purchaser and for a payment of a fixed amount by the seller if certain events occur. As a result, the possible loss and profit that both the buyer and seller can experience is limited and known with certainty at all times. The limited risk of transactions structured similarly to the CME Credit Event contracts, the lack of variation in the loss or profit that they permit independent of trading, and the fact that such contracts can incorporate certain characteristics of vanilla put or call options renders such transactions option contracts that are subject to the CEA when they involve any commodity other than a security.

3. The CME Credit Event Contracts are Based on Commodities

Credit Event contracts are options that transfer a "commodity," from buyer to seller.[33] The CME Credit Event contracts measure the likelihood of the occurrence of specified credit events that will materially impact a Reference Entity's ability to make good on debt obligations. As such, the CME Credit Event contracts patently measure the credit risk of their respective Reference Entities.

CEA Section 1a(4), a definitional provision for the term commodity, includes certain agricultural commodities as well as "all other goods and articles ... and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." CEA Section 1a(13) identifies with specificity "credit risk or measure" and certain occurrences or contingencies associated with financial, commercial, or economic consequences, including changes in the price or value of credit risks or measures, as excluded commodities.[34] Based on

[32] *See* the Memorandum to the Commission, dated February 10, 2004, regarding the application by HedgeStreet, Inc., to be designated as a contract market. The Division, in recommending approval of the HedgeStreet application, noted that HedgeStreet proposed to list for trading European-style binary options, rather than the more conventional futures or option contracts listed on existing exchanges.

[33] For the proposed contracts, the commodity that would be transferred is credit risk.

[34] The CEA Section 1a(13) "excluded commodity" definition is relied upon throughout the CEA in establishing various conditional exclusions from the Act. *See e.g.*, CEA Sections 2(d)(1) and 2(d)(2).

the foregoing, staff concluded that the probability of the occurrence of credit events that materially impact a corporation's ability to make good on its debt obligations, known as credit risks or measures of credit risks, are commodities under the CEA.

4. Credit Event Contracts are Not Securities

As explained above, staff has concluded that a credit risk or measure, and an occurrence that is a change in the level of credit risk or credit measure, is a commodity under the CEA, and that the CME Credit Event contracts are option contracts that may be subject to the CEA. The Division then considered whether binary options that are designed to transfer credit risks from one party to another, when referencing an entity that issues debt securities, are binary options on a security or based on the value of a security. Section 2(a)(1) of the '33 Act and Section 3(a)(10) of the '34 Act define a security to include an option on any security, including an option based on the value of any security. As previously discussed, options on securities, or options based on the value of securities, are explicitly excluded from the regulatory purview of the Commission under CEA Section 2(a)(1)(C).

a. Case Law

Although the Supreme Court has stated that the definition of a security is to be construed in a "flexible" manner,[35] the Court also has cautioned that "[i]n searching for the meaning and scope of the word 'security' . . . the emphasis should be on economic reality."[36] The CME credit event contracts are cash-settled and involve no actual transfer of debt securities. As such, they are not options on securities. Notwithstanding the lack of actual delivery of securities, courts have found that cash-settled options that are based on the value of securities are themselves considered securities pursuant to Section 3(a)(10) of the '34 Act. For example, the U.S. Court of Appeals for the Second Circuit recently applied the "economic reality" test to cash-settled OTC options based

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[35] *See Howey Co.* at 299, note 6 *supra*.

[36] *United Hous. Found. v. Forman*, 421 U.S. 837, 848 (1975) (quoting *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)).

on the yield of debt securities, and held that such options were securities because they were "based on the value" of securities.[37] More recently, the District Court for the Southern District of New York in *Stechler v. Sidley Austin Brown & Wood, LLP*, applied these precedents in evaluating whether a set of privately-negotiated digital options on the Nasdaq 100 index were subject to the securities laws as securities.[38] The court noted that in *Caiola*, the yield-based options at issue were designed to be the "economic equivalent" of traditional options on securities, and thus were securities.[39] The court further observed that the Nasdaq 100 digital options before the court were distinguishable from the yield-based options because they were not designed to replicate standard options.[40]

The court concluded that, if the value of the digital options moved in a manner "sufficiently similar" to that of a standard option, then *Caiola* required the court to find that the digital options were securities.[41] The implication of the statement is that if, however, the price of a financial contract does in fact move in relation to price movements of a security, but does so in a manner that is not sufficiently similar to that of the security to make the instruments economic equivalents, then that financial contract is not necessarily a security. In accordance with the *Stechler* opinion, Division staff has analyzed whether credit event contracts in general, and the bankruptcy-based CME Credit Events contracts in particular, are economically equivalent to debt securities or standard options on the debt securities of Reference Entities.

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[37] *Caiola* at 327.

[38] 382 F.Supp.2d 580 (2005).

[39] It is important to note that, economically, the yield of an obligation of debt is the price that a borrower pays for the ability to temporarily possess liquid assets such as cash. Therefore, an option on the yield of a security can be viewed as an option based on the price of a security. *See* note 26, *supra*.

[40] *Stechler* at 595.

[41] *Stechler* at 596.

At times, changes in the prices of debt securities can, in fact, be negatively correlated to the movement in the trading price of certain credit event contracts. This negative correlation would likely be most apparent for credit event contracts that contain terms that specifically reference credit events directly linked to an entity's debt obligations. That correlation, however, is not derived from the price or value of debt securities, and therefore it is reasonable to conclude that the contracts are not serving effectively as economic equivalents to securities. Option contracts on credit risk are not instruments designed to transfer the price or value of a security from buyer to seller. Rather, they are instruments designed to transfer credit risk, while excluding the other elements of price and value. Credit event contracts isolate, measure, and price credit risk. By doing so, they are financial contracts that can facilitate the accurate pricing of related debt securities by giving value to debt securities, that is, by facilitating the discovery of the value of debt securities, as opposed to being economic equivalents of debt securities that are based on and take on the value of the debt securities.

b. Statutory Provisions

Section 3 of the Act states that "[t]he transactions subject to this Act . . . are affected with a national public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair, and financially secure trading facilities." Credit event contracts, including the CME bankruptcy-based Credit Event contracts, do not transfer the market price or value of securities as do typical options based on the price or value of a security. They transfer credit risk from buyer to seller, and through being traded, create financially-material commercial data. Accordingly, their trading accomplishes precisely what the CEA, as amended by the CFMA, is trying to foster.

The CEA, as amended by the CFMA, recognizes credit risk as a unique interest that is apart and separable from the price or value of a security. It is axiomatic that one of the paramount objectives of the CFMA was to ensure legal certainty for credit risk and other OTC derivatives.

In its deliberations prior to the passage of the CFMA, Congress had ample opportunity to do much more than juxtapose the discussion of credit-risk derivatives and securities. Congress could have taken some step to indicate clearly that credit risk derivatives with terms that link them to securities shall be, for the purposes of extending the securities laws to such derivatives, deemed as based on the value of the debt securities issued by those companies.

The amendments introduced to the CEA by the CFMA, however, did not do so. For instance, the CFMA explicitly exempts swap agreements from the definition of security. Section 206A of the GLB, which was made effective by the CFMA, states that options based on the value of any security or group of securities are securities subject to the securities laws and cannot be considered to be swap agreements. Since the CFMA explicitly exempts OTC swap agreements from the definition of securities, the effect of Section 206A, if construed strictly, is to prohibit credit event contracts that are considered to be options based on the value of securities under the securities laws, even if otherwise compliant with the definition of a swap agreement, from being considered exempt statutory swap agreements. Instead, such instruments, irrespective of their swap-like features, as securities, would be subject to the full panoply of the securities laws.

Pursuant to this reading of Section 206A, an instrument based on a financial contingency or occurrence (such as a credit event) can qualify as a swap agreement, and therefore be statutorily exempt from the definition of security. Likewise, a financial transaction whose terms and conditions require the parties to exchange, on a contingent basis, one or more payments based on the value of commodities or securities can meet the definition of a swap agreement and thereby be statutorily exempt from the definition of security.

According to GLB Section 206A, credit default derivatives, which are often structured as binary options or variants of binary options, can qualify as swap agreements exempt from the securities laws. The content of Section 206A gives eligible contract participants the ability to structure and trade binary options that transfer credit risk, or variants thereof, OTC without

converting the options into securities. In order for such options and transactions to trade OTC legally, they have to be not based on the value of a security or to somehow be deemed to be a special class of options.

The Division, therefore, concludes that, given the structure, design, purpose and use of credit event contracts, including the CME bankruptcy-based Credit Event contracts, and consistent with the GLB Section 206B definition of a security-based swap, credit event contracts in general, and the CME bankruptcy based Credit Event contracts in particular, are not option transactions that are based on securities or on the value of securities. Accordingly, the Division concludes that the CME Credit Event contracts is not a security option and that it is a commodity option subject to the CEA and the Commission's jurisdiction. On that basis, the Division recommends that the Commission take action to approve the CME Credit Event contracts that were submitted to the Commission for approval.

ATTACHMENTS:

A. CME Credit Event Contracts Terms and Conditions.
B. CBOE Comment Letter Dated November 3, 2006.
C. OCC Comment Letter Dated November 3, 2006.
D. CME Comment Letter Dated November 9, 2006.
E. CBOE Comment Letter dated December 5, 2006.
F. CME Comment Letter dated December 11, 2006.
G. CBOE Comment Letter dated December 19, 2006.
H. Draft Commission Approval Letter to CME

U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5260
Facsimile: (202) 418-5527
www.cftc.gov

Division of
Market Oversight

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January 30, 2007

MEMORANDUM

TO: The Commission

FROM: The Division of Market Oversight

SUBJECT: Supplement to Request for Commission Approval Memorandum of the Chicago Mercantile Exchange's Credit Event Futures contracts, based on Centex Corporation, Jones Apparel Group, Inc. and Tribune Corporation; submitted pursuant to Section 5c(c)(2) of the Commodity Exchange Act and Commission Regulation 40.3.

CONCLUSION AND RECOMMENDATION: This Memorandum is responsive to a comment letter from the Chicago Board Options Exchange received by the Commission on January 29, 2007.

Division staff recommends that the Commission approve the proposed CME contracts pursuant to Section 5c(c)(2) of the Commodity Exchange Act. Division staff further recommends that the Commission inform the CME that it considers the proposed contracts to be solely commodity option contracts and that CME should treat the contracts accordingly.

STAFF CONTACTS:

Rose Troia	202-418-5271
Thomas Leahy	202-418-5278
Bruce Fekrat	202-418-5578
David Van Wagner	202-418-5481

The Chicago Board Options Exchange (CBOE),[1] in response to a Commission request for comment, has submitted a supplemental comment letter dated January 26, 2007 (CBOE Letter) regarding the Chicago Mercantile Exchange's (CME) submission of contracts styled

[1] The CBOE is a national securities exchange registered as such with the Securities and Exchange Commission (SEC). The CBOE Futures Exchange, LLC (CFE), a designated contract market, is a wholly owned subsidiary of CBOE. Pursuant to an amended submission to the SEC dated January 16, 2007, the CBOE intends list credit default options on the CBOE as opposed to the CFE.

Credit Event Futures to the Commission for approval.[2] The comment letter raises certain objections and concerns, all of which have been considered and evaluated at length by Division of Market Oversight (Division) staff during the contract review process as reflected in the Division's January 26, 2007 Approval Recommendation Memorandum (Memorandum) to the Commission.

The CBOE letter reiterates the assertion that the CME Credit Event contracts are option contracts and not futures contracts. Division staff, as reflected by the Memorandum to the Commission, considers the CME Credit Event contracts to be options, namely binary options, within the meaning of the Commodity Exchange Act (CEA or Act).[3]

The second issue raised by the CBOE Letter, as set forth in a prior letter dated December 19, 2006, argues that binary option contracts that are triggered only by the occurrence of a bankruptcy event, such as the CME Credit Event contracts, even though they do not reference any securities, are securities. The CBOE contends that a bankruptcy event is merely a proxy for an express reference to the valuation of debt securities and results in defaults on debt securities. The CBOE Letter states that a bankruptcy event is "inextricably linked to debt securities," and that the CME's limitation of triggering events to bankruptcies is "a creative attempt to obfuscate the link between the CME Product and a Reference Entity's securities..." The CBOE thus concludes that the CME contracts are linked to the value of debt securities, and thereby, are based on securities.

DMO staff observes that, under current law, an option is clearly a security when it is "on" a security, that is, at a minimum, based on the physical exchange of a security. Also, an

[2] The Division notes that the CBOE Letter was received by the Commission on January 29, 2007. The statutorily-established review period for the Commission's consideration of the proposed CME Credit Event contract will end on January 31, 2007.

[3] Division staff notes, however, that it does not opine on whether binary options that are based on credit risk or measures of credit risk, or binary options that are structured and traded so as to not be based on the value of securities, are options within the meaning of the securities laws, regardless of incorporating material contractual terms that are linked to equity or debt securities.

option is clearly a security when it is based on the market value of a security. DMO staff does not believe, however, that there is any basis, as CBOE urges, for reading the plain statutory definition of a security in the Securities Act of 1933 ('33 Act) and the Securities and Exchange Act ('34 Act) to render an option a security when it is merely linked to a security and thereby can be viewed semantically as "based on a security." Such an expansive interpretation would convert any cash-settled instrument with option-like features into securities, even though such instruments may not in any way transfer the value of securities from one party to another, merely because the instrument has some explicit or implicit contractual term that links it to a security. As Congress clearly indicated in Gramm-Leach-Bliley Section 206B, option-like financial contracts that are not based on the value of a security can have contract terms that are linked to the value of securities yet exist within the universe of financial instruments that are not regulated at the federal level or are regulated by a regulatory body other than the SEC.

As analyzed in the Memorandum, and as recognized by CBOE in its January 16, 2007 SEC filing for its proposed new credit default option contracts, "creditworthiness is viewed as a key component of the valuation of a debt security." In other words, credit default contracts, as derivatives that measure the creditworthiness of an entity, facilitate the pricing of debt instruments rather than being based on the value of debt instruments. Interpreting the phrase "based on the value of a security" to include any financial contract feature that gives value to a security is a novel interpretation that is inapposite to the plain statutory text of the '33 and '34 Acts that defines the term security.[4]

The CBOE Letter also raises a concern that the CME bankruptcy contracts, if they are not considered to be securities, will permit a Reference Entity's insiders and tippees to trade

[4] Under the CBOE interpretation, an option contract based on the rate of inflation would be a security because the nominal yield on a security, and therefore its price, is based on the expected inflation rate.

contracts without being subject to the legal prohibitions against insider trading imposed under the securities laws. According to the CBOE, such activity would not violate any provision of the CEA and would not otherwise be subject to Commission sanction.

DMO staff would make the following observations regarding this purported "regulatory gap." First, the Division points out that the trillion dollar market for credit derivatives is presently largely an unregulated market. It is not clear whether or not all structured credit derivatives, which could presumably be traded by corporate insiders, are considered to be security-based swaps, that is, considered to include a material term that is based on the price or value of a security, and thereby, subject to the law of insider trading. If such "gaps" exist, then they have most likely existed for some time without giving rise to CBOE's concern that important principles of market fairness, integrity and public policy are compromised. Second, as a practical matter, if traders lose confidence in the efficacy of a contract and believe that credit event contracts are traded by insiders or tippees because securities insider trading laws are inapplicable, then such contracts would on their face fail to garner the liquidity they need to trade successfully.

Lastly, the CBOE's reliance on the potential inapplicability of certain securities laws ignores the fact that credit event contracts, when traded subject to the rules of a designated contract market, would be traded openly, competitively, and under the surveillance of derivatives markets that are self-regulatory bodies operating pursuant to the provisions of the CEA and the Commission's regulations thereunder. The trading of credit event contracts on designated contract markets would be subjected to a comprehensive regulatory regime that is overseen by the Commission. As part of its regulatory charge, the Commission, independent of the surveillance obligations of the designated contract markets, directly surveils the trading of contracts on designated contract markets on a daily basis.

The comprehensive regulatory system established by the CEA, which has been structured in part specifically for exchange traded derivatives products, is designed to protect traders and the integrity of the markets. The Division notes that the CEA gives the Commission plenary authority to regulate commodity option contracts, such as the credit event contracts, in any manner that is consistent with the customer protection and maintenance of market integrity purposes of the CEA. Accordingly, Commission has the ability to respond to market innovation through the adoption of principles-based regulations that protect the interests of traders and the integrity of markets, yet manage to not impose undue prescriptive regulatory burdens that, when analyzed through cost-benefit analyses, may not benefit the public's interest.

The CBOE letter concludes by stating that "any subsequent submissions by CME respecting credit-related products should be filed for Commission approval and subject to public comment." Division staff notes that, under the CEA, the CME, as a designated contract market, is permitted to self-certify any new product or amendments to the terms and conditions of any existing product, except contracts on enumerated agricultural commodities. The decision to self-certify or seek Commission approval of any filings involving credit-related contracts is a decision that the CEA entrusts to the CME. The Commission is statutorily constrained from requiring the CME to seek approval in the manner suggested by CBOE.

EXHIBIT C

(h) On RB211–535E4–B engines:

(1) Ultrasonically inspect the fan blade root, and if required, relubricate using one of the methods in Table 4 of this AD.

(2) If the initial inspection is complete prior to 18,800 CSN, then the next inspection may be postponed until 20,000 CSN.

TABLE 4—RB211–535E4–B

Engine location	Initial inspection within (CSN)	Type action	In accordance with MSB	Repeat inspection within (CSLI)
(i) On-wing	20,000	(A) Root Probe inspect, OR	RB.211–72–C879 Revision 6, 3.A.(1) through 3.A.(7), dated December 14, 2007.	1,200
		(B) Wave Probe inspect	RB.211–72–C879 Revision 6, 3.B.(1) through 3.B.(7), dated December 14, 2007.	1,000
(ii) In shop	20,000	Root Probe inspect. Relubricate if blade life is more than 19,650 cycles.	RB.211–72–C879 Revision 6, 3.C.(1) through 3.C.(4), dated December 14, 2007.	1,200

(i) For fan blades operated to any combination of RB211–535E4 Flight Profile A, –535E4 Flight Profile B, –535E4–B, –535E4–B and –535E4–C engines:

(1) Calculate an equivalent CSN as defined in the Time Limits Manual. See References Section 1.G.(3), of MSB RB.211–72–C879, Revision 6, dated December 14, 2007.

(2) For fan blades that are currently flying in Profile A, inspect using paragraph (f) and Table 2 of this AD using equivalent CSN.

(3) For fan blades that are currently flying in Profile B, inspect using paragraph (g) and Table 3 of this AD using equivalent CSN.

(4) For fan blades that are currently flying in an RB211–535E4–B engine, inspect using paragraph (h) and Table 4 of this AD using equivalent CSN.

Optional Terminating Action

(j) Application of Metco 58 blade root coating using RR SB No. RB.211–72–C946, Revision 2, dated September 26, 2002, constitutes terminating action to the repetitive inspection requirements specified in paragraphs (f), (g), (h), and (i) of this AD.

Alternative Methods of Compliance

(k) The Manager, Engine Certification Office, has the authority to approve alternative methods of compliance for this AD if requested using the procedures found in 14 CFR 39.19.

Previous Credit

(l) Inspections and relubrication done before the effective date of this AD that use AD 2003–12–15 (Amendment 39–13200, 68 FR 37735, June 25, 2003), RR MSB No. RB.211–72–C879, Revision 3, dated October 9, 2002, MSB No. RB.211–72–C879, Revision 4, dated April 2, 2004, or MSB No. RB.211–72–C879, Revision 5, dated March 8, 2007, comply with the requirements specified in this AD.

Related Information

(m) United Kingdom Civil Aviation Authority airworthiness directive AD 002–01–2000, dated October 9, 2002, also addresses the subject of this AD.

(n) Contact Ian Dargin, Aerospace Engineer, Engine Certification Office, FAA, Engine and Propeller Directorate, 12 New England Executive Park, Burlington, MA 01803; *e-mail: ian.dargin@faa.gov; telephone:* (781) 238–7178; *fax:* (781) 238–7199, for more information about this AD.

Material Incorporated by Reference

(o) You must use Rolls-Royce plc Mandatory Service Bulletin No. RB.211–72–C879, Revision 6, dated December 14, 2007 to perform the inspections and relubrication required by this AD. The Director of the Federal Register approved the incorporation by reference of this service bulletin in accordance with 5 U.S.C. 552(a) and 1 CFR part 51. Contact Rolls-Royce plc, PO Box 31, Derby, England, DE248BJ; *telephone:* 011–44–1332–242424; *fax:* 011–44–1332–249936, for a copy of this service information. You may review copies at the FAA, New England Region, 12 New England Executive Park, Burlington, MA; or at the National Archives and Records Administration (NARA). For information on the availability of this material at NARA, call 202–741–6030, or go to: *http://www.archives.gov/federal-register/cfr/ibr-locations.html.*

Issued in Burlington, Massachusetts, on October 23, 2008.

Peter A. White,

Assistant Manager, Engine and Propeller Directorate, Aircraft Certification Service.

[FR Doc. E8–25891 Filed 11–3–08; 8:45 am]

BILLING CODE 4910–13–P

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 190

Interpretative Statement Regarding Funds Related to Cleared-Only Contracts Determined To Be Included in a Customer's Net Equity

AGENCY: Commodity Futures Trading Commission.

ACTION: Interpretative Statement; correction.

SUMMARY: This interpretation by the Commodity Futures Trading Commission ("Commission") is issued to clarify the appropriate treatment under the commodity broker provisions of the Bankruptcy Code and Part 190 of the Commission's Regulations of claims arising from contracts ("cleared-only contracts") that, although not executed or traded on a Designated Contract Market or a Derivatives Transaction Execution Facility, are subsequently submitted for clearing through a Futures Commission Merchant ("FCM") to a Derivatives Clearing Organization ("DCO"). The Commission first published this interpretation in the **Federal Register** of October 2, 2008 (73 FR 57235). A statement of concurrence on a different matter was printed at the end of the interpretation, in error. The Commission is republishing the interpretation to clarify that the statement of concurrence is not related to the interpretation.

FOR FURTHER INFORMATION CONTACT: Robert B. Wasserman, Associate Director, *rwasserman@cftc.gov,* (202) 418–5092, or Amanda Olear, Attorney-Advisor, Division of Clearing and Intermediary Oversight, *aolear@cftc.gov,* (202) 418–5283, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.

Section 20 of the Commodity Exchange Act[1] (Act) empowers the Commission to provide how the net equity of a customer is to be determined:

> The Commission may provide, with respect to a commodity broker that is a debtor under chapter 7 of title 11 of the United States Code, by rule or regulation— (1) that certain cash, securities, other property, or commodity contracts are to be included in or excluded from customer property or member property; * * * and (5) how the net equity of a customer is to be determined.

Subchapter IV of Chapter 7 of the Bankruptcy Code, governing commodity brokers, has the same effect, explicitly basing the definition of "net equity" on

[1] 7 U.S.C. 24.

"such rules and regulations as the Commission promulgates under the Act." [2]

The Commission has exercised this power in promulgating Part 190 of its regulations.[3] In particular, the term "net equity" is defined by Commission Regulation 190.07 [4] as:

> The total claim of a customer against the estate of the debtor based on the commodity contracts held by the debtor for or on behalf of such customer less any indebtedness of the customer to the debtor.

Therefore, the determination of whether claims relating to cleared-only contracts in section 4d accounts are properly includable within the meaning of "net equity" is dependent upon whether an entity holding such claims is properly considered a "customer." This, in turn, as discussed below, requires an analysis of whether such claims are derived from "commodity contracts."

Cleared-Only Transactions as Commodity Contracts

Commission Regulation 190.01(k) defines "customer" through incorporation by reference of the definition of the term appearing in section 761(9) of the Bankruptcy Code, which provides, in relevant part:

> (9) "Customer" means—
>
> (A) With respect to a futures commission merchant—
>
> (i) Entity for or with whom such futures commission merchant deals and holds a claim against such futures commission merchant on account of a *commodity contract* made, received, acquired, or held by or through such futures commission merchant in the ordinary course of such future commission merchant's business as a futures commission merchant from or for the commodity futures account of such entity; or
>
> (ii) Entity that holds a claim against such futures commission merchant arising out of—
>
> (I) The making, liquidation, or change in the value of a *commodity contract* of a kind specified in clause (i) of this subparagraph;
>
> (II) A deposit or payment of cash, a security, or other property with such futures commission merchant for the purpose of making or margining such a *commodity contract;* or
>
> (III) The making or taking of delivery on such a *commodity contract*[.] [5]

Therefore, for an entity to be considered a "customer" of an FCM, such entity's claim must arise out of a "commodity contract." [6]

A "commodity contract," as the term appears within the context of section 761(9), is defined in section 761(4) of the Bankruptcy Code, which states, in pertinent part:

> (4) "*Commodity Contract*" means—
>
> (A) With respect to a futures commission merchant, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade[.] [7]

This definition contains two elements: (1) The nature of the contract; and (2) the nature of the venue whose rules govern the contract.

With regard to the first element, over-the-counter contracts that are cleared-only contracts are contracts for the purchase or sale of a commodity for future delivery within the meaning of this section of the Bankruptcy Code. When cleared, they are subject to performance bond requirements, daily variation settlement, the potential for offset, and final settlement procedures that are substantially similar, and often identical, to those applicable to exchange-traded products at the same clearinghouse. *Cf.* 11 U.S.C. 761(4)(F). Although the creation and trading of these products is outside the Commission's jurisdiction, the clearing of these products by FCMs and DCOs is within the Commission's jurisdiction.

With regard to the second element, section 761(7) of the Bankruptcy Code states that a "'contract market' means a registered entity," and section 761(8), in turn, provides that a "'registered entity' * * * ha[s] the meaning[ ] assigned to [that] term[ ] in the [Commodity Exchange] Act." [8] Section 1a(29)(C) of the Act defines the term "registered entity" as including "a derivatives clearing organization registered under section 5b" of the Act.[9]

Thus, when a contract is cleared through a DCO, such a contract would be considered a "commodity contract" under section 761(4) of the Bankruptcy Code.[10] Therefore, an entity with a claim based on a cleared-only contract would be a "customer" within the meaning of section 761 of the Bankruptcy Code. Further, because Part 190 of the Commission's Regulations defines "customer" as having the meaning set forth in section 761, such entity with a claim based on a cleared-only contract would also be a "customer" for the purposes of Part 190 of the Commission's Regulations. Based on the foregoing, such claims arising out of cleared-only contracts are properly included within the meaning of "net equity" for the purposes of Subchapter IV of the Bankruptcy Code and Part 190 of the Commission's Regulations.

Portfolio Performance Bond as Net Equity

There is an alternative path to reach the same conclusion. In cases where cleared-only contracts are held in a commodity futures account at an FCM and margined as a portfolio with exchange-traded futures (*i.e.*, where the Commission has issued an order pursuant to section 4d(a)(2) of the Commodity Exchange Act), assets margining that portfolio are likely to be includable within "net equity" even if cleared-only contracts were found not to be "commodity contracts" within the meaning of the Bankruptcy Code and Part 190 of the Commission's Regulations.

Where the assets in an entity's account margin (*i.e.*, collateralize) both cleared-only contracts and exchange-traded futures, the entirety of those assets serves as performance bond for each of the exchange-traded futures and the cleared-only contracts. Therefore, (a) a claim for those assets constitutes a claim "on account of a commodity contract made, received, acquired, or held by or through such futures commission merchant in the ordinary course of such future commission merchant's business as a futures commission merchant from or for the commodity futures account of such entity;" [11] (b) the entity qualifies as a "customer" within the meaning of the Bankruptcy Code as a result of that claim; and (c) those margin assets are properly included within that entity's net equity.

The dynamics of futures trading render it unwise to distinguish between an account that *currently* is portfolio margined and one that was at one time or is intended to be so in the future. Indeed, Subchapter IV of the Bankruptcy Code includes as customers entities with certain claims arising out of property that is not currently margining a commodity contract. Specifically, section 761(9)(A)(ii) provides that an entity can qualify as a "customer" based on claims arising out of any of the following: (I) The "liquidation, or change in the value of a commodity contract;" (II) a deposit of property "for the purpose of making or margining * * * a commodity contract;" or (III) "the making or taking of delivery of a commodity contract."

[2] 11 U.S.C. 761(17).

[3] 17 CFR Part 190.

[4] 17 CFR 190.07.

[5] 11 U.S.C. 761(9) (emphasis added).

[6] A similar analysis would apply to a customer of a clearing organization (*i.e.*, a clearing member).

[7] 11 U.S.C. 761(4).

[8] 11 U.S.C. 761(7) and (8).

[9] 7 U.S.C. 1a(29)(C).

[10] *Cf.* H.R. Rep. No. 109–31(I) (2005) (emphasizing distinction between definitions for purposes of Bankruptcy Code and for purposes of other statutes).

[11] Section 761(9)(A) of the Bankruptcy Code provides that an entity holding such a claim is a "customer." 11 U.S.C. 761(9)(A).

Accordingly, there is no requirement that the customer's assets be margining commodity contracts on the day that the bankruptcy petition is filed. Therefore, all assets contained in such an account are properly included within the customer's net equity.

Account Classes

Part 190 of the Commission's Regulations divides accounts into several classes, specifically: Futures accounts, foreign futures accounts, leverage accounts, commodity option accounts, and delivery accounts.[12]

In October 2004, the Commission issued an interpretation regarding the appropriate account class for funds attributable to contracts traded on non-domestic boards of trade, and the assets margining such contracts, that are included in accounts segregated in accordance with Section 4d of the Act pursuant to Commission Order.[13] In that context, the Commission concluded that the claim is properly against the Section 4d account class because customers whose assets are deposited in such an account pursuant to Commission Order should benefit from that pool of assets. The same rationale supports the Commission's conclusion that a claim arising out of a cleared-only contract, or the property margining such a contract, would be includable in the futures account class where, pursuant to Commission Order, the contract or property is included in an account segregated in accordance with Section 4d of the Act.

* * * * *

Issued in Washington, DC, on September 26, 2008, by the Commodity Futures Trading Commission.

David Stawick,

Secretary of the Commission.

[FR Doc. E8–26199 Filed 11–3–08; 8:45 am]

BILLING CODE 6351–01–P

[12] *See* 17 CFR 190.01.

[13] *See* Interpretative Statement Regarding Funds Determined To Be Held in the Futures Account Type of Customer Account Class, 69 FR 69510 (Nov. 30, 2004).

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 232 and 270

[Release Nos. 33–8981; 34–58874; IC–28476 File No. S7–25–07]

RIN 3235–AJ81

Mandatory Electronic Submission of Applications for Orders Under the Investment Company Act and Filings Made Pursuant to Regulation E

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: We are adopting several amendments to rules regarding our Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system. Specifically, we are amending our rules to make mandatory the electronic submission on EDGAR of applications for orders under any section of the Investment Company Act of 1940 ("Investment Company Act") as well as Regulation E filings of small business investment companies and business development companies. We also are amending the electronic filing rules to make the temporary hardship exemption unavailable for submission of applications under the Investment Company Act. Finally, we are amending Rule 0–2 under the Investment Company Act, eliminating the requirement that certain documents accompanying an application be notarized and the requirement that applicants submit a draft notice as an exhibit to an application.

DATES: *Effective Date:* January 1, 2009.

FOR FURTHER INFORMATION CONTACT: If you have questions about the rules, please contact one of the following members of our staff in the Division of Investment Management, at the Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–0506: in the Office of Legal and Disclosure, Ruth Armfield Sanders, Senior Special Counsel (EDGAR), at (202) 551–6989; in the Office of Investment Company Regulation, Michael W. Mundt, Assistant Director, at (202) 551–6821; or, in the Office of Insurance Products, Keith Carpenter, Senior Special Counsel, at (202) 551–6766; for technical questions relating to the EDGAR system, in the Office of Information Technology, Richard D. Heroux, EDGAR Program Manager, at (202) 551–8168.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") is adopting amendments to Rules 101 and 201 of Regulation S–T [1] relating to electronic filing on the EDGAR system and to Rule 0–2 [2] under the Investment Company Act.[3]

I. Background

In the last several years, we initiated a series of amendments to keep EDGAR current technologically and to make it more useful to the investing public and Commission staff.[4] In April 2000, we adopted rule and form amendments in connection with the modernization of EDGAR.[5] In the Modernization Proposing Release, we noted that, as the use of electronic databases grows, it becomes increasingly important for members of the public to have electronic access to our filings. We also stated that we were contemplating future rulemaking to require more of our filings to be filed on EDGAR. In May 2002, we adopted rules requiring foreign private issuers and foreign governments to file most of their documents electronically.[6] In May 2003, we adopted rules requiring electronic filing of beneficial ownership reports filed by officers, directors and principal security holders under section 16(a) [7] of the Securities Exchange Act of 1934 ("Exchange Act").[8] In July 2005, we adopted rules requiring certain open-end management investment companies and insurance companies separate accounts to identify in their EDGAR submissions information relating to their series and classes (or contracts, in the case of separate accounts) and mandating that fidelity bonds filed under section 17(g) [9] and sales literature filed with us under section 24(b) [10] be

[1] 17 CFR 232.101 and 232.201.

[2] 17 CFR 270.0–2.

[3] We proposed these amendments in November 2007. *See* Rulemaking for EDGAR System; Mandatory Electronic Submission of Applications for Orders under the Investment Company Act and Filings Made Pursuant to Regulation E, Release No. 33–8859 (Nov. 1, 2007) [72 FR 63513 (Nov. 9, 2007)] ("Proposing Release").

[4] We recently announced the successor to the EDGAR Database. The new system is called IDEA, short for Interactive Data Electronic Applications, and will at first supplement and then eventually replace the EDGAR system. *See* "SEC Announces Successor to EDGAR Database; "IDEA" Will Make Company and Fund Information Interactive," Press Release No. 2008–179, Aug. 19, 2008.

[5] *See* Rulemaking for EDGAR System, Release No. 33–7855 (Apr. 27, 2000) [65 FR 24788] (the "Modernization Adopting Release"). *See also* Release No. 33–7803 (Mar. 3, 2000) [65 FR 11507] ("Modernization Proposing Release").

[6] *See* Mandated EDGAR Filing for Foreign Issuers, Release No. 33–8099 (May 14, 2002) [67 FR 36678].

[7] 15 U.S.C. 78p(a).

[8] *See* Mandated EDGAR Filing and Web Site Posting for Forms 3, 4 and 5, Release No. 33–8230 (May 7, 2003) [68 FR 25788] (the "EDGAR Section 16 Release").

[9] 15 U.S.C. 80a–17(g).

[10] 15 U.S.C. 80a–24(b).