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COMMODITY FUTURES TRADING COMMISSION (CFTC)

17 CFR Part 35

Exemption for Certain Swap Agreements

58 FR 5587

DATE: Friday, January 22, 1993

ACTION: Final rule.

[*5587]

SUMMARY: On November 12, 1992, the Commodity Futures Trading Commission ("Commission") published for comment proposed new part 35 (the "Proposal") n1 which would exempt swap agreements (as defined herein) meeting specified criteria from regulation under the Commodity Exchange Act (the "Act"). This rule was proposed pursuant to authority recently granted the Commission, a purpose of which is to give the Commission a means of improving the legal certainty of the market for swap agreements. The original 30 day comment period was extended 14 days and closed December 28, 1992. n2

n 1 57 FR 53627.

n 2 57 FR 58423.

The Commission has carefully considered the comments received and, based upon its review of the comments and its own reconsideration of the proposed rule, has determined to adopt part 35 in modified form, as discussed herein.

EFFECTIVE DATE: February 22, 1993.

FOR FURTHER INFORMATION CONTACT: Joanne T. Medero, General Counsel, Pat G. Nicolette, Deputy General Counsel, or David R. Merrill, Deputy General Counsel, Office of the General Counsel, Commodity Futures Trading Commission, 2033 K Street, NW., Washington, DC 20581. Telephone: (202) 254-9880.

SUPPLEMENTARY INFORMATION:

I. Statutory and Other Background

Section 2(a)(1)(A) of the Commodity Exchange Act ("CEA" or "Act") grants the Commission exclusive jurisdiction over "accounts, agreements (including any transactions which is of the character of * * * an 'option' * * *), and transactions involving contracts of sale of a commodity for future delivery traded or executed on a contract market * * * or any other board of trade, exchange, or market * * *." 7 U.S.C. 2. The CEA and Commission regulations require that transactions in commodity futures contracts and commodity option contracts, with narrowly defined exceptions, occur on or subject to the rules of contract markets designated by the Commission.

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n 3 Sections 4(a), 4c(b) and 4c(c) of the Act; 7 U.S.C. 6(a), 6c(b), 6c(c). Section 4(a) of the CEA specifically provides, *inter alia*, that it is unlawful to enter into a commodity futures contract that is not made "on or subject to the rules of a board of trade which has been designated by the Commission as a 'contract market' for such commodity." 7 U.S.C. 6(a). This prohibition does not apply to futures contracts made on or subject to the rules of a foreign board of trade, exchange or market. 7 U.S.C. 6(a).

On October 28, 1992, the Futures Trading Practices Act of 1992 ("1992 Act") was signed into law. n4 This legislation added new subsections (c) and (d) to section 4 of the Act. New section 4(c)(1) authorizes the Commission, by rule, regulation, or order, to exempt any agreement, contract or transaction, or class thereof, from the exchange-trading requirement of section 4(a) or any other requirement of the Act other than section 2(a)(1)(B). n5 New section 4(c)(2) provides that the Commission may not grant an exemption from the exchange-trading requirement of the Act unless, *inter alia*, the agreement, contract, or transaction will be entered into solely between appropriate persons listed in new section 4(c)(3), and the Commission determines that the agreement, contract, or transaction in question will not have a material adverse affect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the Act. n6

n 4 Pub. L. 102-546.

n 5 Section 4(c)(1), 7 U.S.C. 6(c)(1), reads as follows:

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

n 6 Section 4(c)(2), 7 U.S.C. 6(c)(2), reads as follows: The Commission shall not grant any exemption from any of the requirements of subsection (a) unless the Commission determines that -- (A) The requirement should not be applied to the agreement, contract, or transaction for which the exemption is sought and that the exemption would be consistent with the public interest and the purposes of this Act; and (B) The agreement, contract, or transaction -- (i) Will be entered into solely between appropriate persons; and (ii) Will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or

self-regulatory duties under this Act. In this regard, the Conference Report on the 1992 Act states: The Conferees do not intend for this provision to allow an exchange or any other existing market to oppose the exemption of a new product solely on grounds that it may compete with or draw market share away from the existing market. H.R. Rep. No. 978, 102d Cong., 2d Sess. 79 (1992).

Finally, new section 4(c)(5)(B) of the Act authorizes the Commission to exercise "promptly" the exemptive authority granted in section 4(c)(1) and to exempt swap agreements that are not part of a fungible class of agreements that are standardized as to their material economic terms to the extent that these instruments may be considered as subject to regulation under the Act. n7

n 7 Specifically, new section 4(c)(5)(B) states the Commission may: (B) Promptly following the enactment of this subsection, or upon application by any person, exercise the exemptive authority granted under paragraph (1) effective as of October 23, 1974, with respect to classes of swap agreements (as defined in *section 101 of title 11, United States Code*) that are not part of a fungible class of agreements that are standardized as to their material economic terms, to the extent that such agreements may be regarded as subject to the provisions of this Act.

Pursuant to this new authority, the Commission on November 5, 1992 proposed rules to be set forth in a new part 35 that generally would exempt certain swap agreements from the Act. 57 FR 53627 (Nov. 12, 1992). The comment period, which had been extended by the Commission, expired on December 28, 1992.

The Commission has received in excess of 30 comment letters on the Proposal. The commenters included four futures exchanges; commercial banks, investment banks and other swap market participants; bank, securities industry, futures industry, and other trade associations; bar associations and law firms; government departments and agencies and members of the U.S. House of Representatives. Comments received after December 28 have been considered to the extent the Commission has been able to do so. All commenters, except the four futures exchanges and one commodity trade association, supported the Proposal but suggested modifications or clarifications to certain aspects of its provisions. These [*5588] commenters generally expressed the view that Part 35 would provide greater legal certainty to swap agreements, promote the development of certain financial safeguards in the swap market, and allow U.S. swap market participants to more effectively compete with foreign participants. Three of the four futures exchanges filed a joint comment letter (hereinafter the "Futures Exchanges Letter") which opposed the proposal on procedural and substantive grounds. Similar issues were raised in the other comment letter filed separately by a futures exchange. n8

n 8 The exchanges questioned the adequacy of the comment period for the rulemaking, noting that the Commission has employed a 60 day comment period in other instances. There is, of course, no legal impediment to the Commission's use of a 30 or 44 day comment period in this rulemaking, as the Administrative Procedure Act requires no fixed period for the submission of comments. *Phillips Petroleum Co. v. Environmental Protection Agency*, 803 F.2d 545 (10th Cir. 1986). The Commission notes, however, that its initial selection of 30 days was prompted by its desire to act "promptly" as Congress intended, and the fact that the swaps issue had already been subject to lengthy and careful consideration by both the Commission and the Congress over the past several years. See, e.g. Hearings on S. 207 before the Senate Committee on Agriculture, Nutrition, and Forestry, 102d Cong., 1st Sess. 452 (1991); Advanced Notice of Proposed Rulemaking, 52 FR 47022 (Dec. 11, 1987).

As discussed below, the Commission believes that part 35, as adopted, is responsive to the concerns of the commenters and has determined that it meets the criteria for the issuance of exemptive rules set forth in the Act.

II. Discussion

A. Scope of Rule

Several comment letters, including the Futures Exchanges Letter, have noted the Commission's efforts, both legislative and regulatory, to provide legal certainty for swap agreements. The Commission's review of the regulatory issues raised by swap agreements resulted in the issuance in July 1989 of a Statement of Policy ("Policy Statement") concerning certain swap transactions which recognized a non-exclusive safe harbor for transactions satisfying the statement's criteria. n9 Although the Policy Statement provided much needed clarity at that time concerning the regulatory treatment of swaps, Congress, in enacting the 1992 Act, encouraged the Commission to act promptly to issue an exemption to promote legal certainty in this area. n10 New part 35 is intended to promote domestic and international market stability, reduce market and liquidity risks in financial markets, including those markets (such as futures exchanges) linked to the swap market, and eliminate a potential source of systemic risk. To the extent that swap agreements may be regarded as subject to the provisions of the Act, the rules provide that those swap agreements which meet the terms and conditions set forth therein are exempt from all provisions of the Act, except section 2(a)(1)(B). n11 Although the Commission proposed to reserve certain non-regulatory sections of the Act from the exemption, the Commission agrees with those commenters that this reservation is unnecessary. n12 Nevertheless, in response to suggestions made in the Futures Exchanges Letter and the letter from the fourth commodity exchange, and to the extent that swap agreements may be deemed to be subject to the Act, the Commission has determined specifically to reserve in these rules the antifraud authority applicable to futures contracts and option transactions set forth in Sections 4b and 4o of the Act and Commission Rule 32.9, 17 CFR 32.9 (1992).

n 9 54 FR 30694 (July 21, 1989). The Commission has also recognized, as have others, that certain swap transactions may fall within the Act's jurisdictional exclusions for forward contracts, or the so-called Treasury Amendment or within the Commission's regulatory trade option exemption. *Id.* at 30695, *fn.* 12-15. To the extent that swaps transactions do not meet the exemptive criteria of part 35, but nevertheless fall within the trade option exemption, they will continue to be covered by that provision.

n 10 In granting exemptive authority to the Commission under new section 4(c), the Conferees on the 1992 Act: recognize[d] the need to create legal certainty for a number of existing categories of instruments which trade today outside the forum of a designated contract market. These instruments may contain some features similar to those of regulated exchange-traded products but are sufficiently different in their purpose, function, design, or other characteristics that, as a matter of policy, traditional futures regulation and the limitation of trading to the floor of an exchange may be unnecessary to protect the public interest and may create an inappropriate burden on commerce. H.R. Rep. No. 978, 102d Cong., 2d Sess. 80 (1992). The Futures Exchanges Letter questions whether the Commission was "directed" by Congress to act promptly in issuing this exemption. A fair reading of section 4(c)(5) and the Conference Report indicates a clear expectation by Congress that the Commission would act promptly. H.R. Rep. No. 978, 102d Cong., 2d Sess. 81 (1992). If the word "promptly" is to be given effect, as it must under rules of statutory construction, its plain meaning argues for agency action sooner rather than later. Indeed the Commission was urged "to act and act swiftly." *Id.* There is no requirement for the Commission to wait until the completion of the study requested by Congress. In fact, Congress expected the Commission to exercise its exemptive authority before

the study was completed. *Id.* at 83. In addition, once an agency is granted rulemaking authority it may proceed on a timetable established in its discretion, absent statutory language to the contrary.

n 11 Numerous commenters asked that the Commission clarify its views regarding the section 2(a)(1)(B) limitation, part of the Shad/Johnson Jurisdictional Accord. As stated in the Proposal, by enactment of this part 35 the Commission does not intend to affect transactions undertaken in accordance with the Policy Statement. Further, in enacting this limitation, Congress "did not intend to call into question the legality of securities-based swap or other transactions which occur in the private marketplace at the present time, that do not violate the Accord." H.R. Rep. No. 978, 102d Cong., 2d Sess. 78 (1992). Swap market participants may continue to rely on the Policy Statement for existing and new swap agreements, including securities-based swaps.

n 12 These proposed reservations encompassed sections 1a and 2(b), definitions; section 4(c) and 4(d), the exemptive authority provisions; section 8 dealing with, among other things, the Commission's treatment of confidential information; and, section 12(e)(2)(A), regarding the non-applicability of certain state laws to agreements exempted under section 4(c). By eliminating the reservations as applied to swap agreements, the Commission does not intend to suggest that these sections or any other section of the Act do not continue to apply to the Commission or to its authority and obligations under these sections or to any person or transaction not eligible for the exemption. See section 4(d) of the Act. Pursuant to its authority in new section 4(d) of the Act, the Commission intends routinely to consult with other regulators who have information concerning swap transactions, *e.g.*, the Securities and Exchange Commission pursuant to its risk assessment authority under the Market Reform Act of 1990, the Federal Reserve Board and other bank regulators to seek to assure they include in their routine examination program these transactions. Under section 4(d), the Commission would exercise its authority to investigate, as appropriate. The Commission also specifically wishes to make clear that those provisions of sections 69(c) and 9(a)(2) of the Act concerning manipulation or attempted manipulation of the market price of any commodity in interstate commerce or for future delivery on or subject to the rules of any contract market, would continue to apply to persons engaging in swap agreements but not to the swap agreements themselves. Part 35 does not affect the applicability or protections of state law (other than gaming or "bucket shop" laws), including applicable securities laws or antifraud statutes of general applicability, to these swap agreements or any other protections provided by other applicable federal laws. Congress specifically noted that, in exempting an instrument from the Act, the Commission cannot exempt it from applicable securities and banking laws and regulations. H.R. Rep. No. 978, 102d Cong., 2d Sess. 83 (1992).

The rule is retroactive and effective as of October 23, 1974, the date of enactment of the Commodity Futures Trading Commission Act of 1974. The exemption would thus implement Congressional intent that the exemption from the Act be available for all eligible swap agreements, regardless of when (subsequent to October 23, 1974) the agreements may have been entered into. The issuance of this rule should not be construed as reflecting any determination that the swap agreements covered by the terms hereof are subject to the Act, as the Commission has not made and is not obligated to make any such determination. n13

n 13 The contention expressed in the Futures Exchanges Letter that the Commission must make such a determination ignores the express language of 4(c)(5) and misstates Congressional intent as expressed in the Conference Report: The Conferees do not intend that the exercise of exemptive authority * * * would require any determination beforehand that the agreement * * * is subject to the Act * * *. Rather than making

a finding as to whether a product is or is not a futures contract, the Commission in appropriate cases may proceed directly to issuing an exemption. H.R. Rep. No. 978, 102 Cong., 2d Sess. 82-83 (1992). The Futures Exchanges Letter advocates the view that to provide legal certainty to swap agreements the Commission need only exempt such agreements from the requirements of section 4(a) of the Act. The Commission does not read Congressional intent or its authority under section 4(c) so narrowly and has determined to exempt swap agreements which satisfy the requirements of the rule from regulation under the Act. **[*5589]**

In enacting this exemptive rule, the Commission is also acting under its plenary authority under section 4c(b) of the Act with respect to swap agreements that may be regarded as commodity options. n14 The rule also exempts, as permitted by section 4(c)(1), all persons and entities for the activity of offering, entering into, rendering advice, or rendering other services with respect to swap agreements covered by the rule. Commenters indicated that the placement of this language in the rule was confusing. Accordingly, a clarifying modification has been made. Such persons, however, engaged in activity otherwise subject to the Act would not be exempt for such activity, even if it were connected to their exempted swaps activity. Also in this regard, the Commission wishes to make clear that the exemption does not apply to any financial, recordkeeping, reporting, or other requirements imposed on any person in connection with their activities that remain subject to regulation under the Act. n15 Thus, for example, futures commission merchants must continue to account for any liabilities arising out of any swap agreement in meeting the net capital requirements of Commission Rule 1.17 just as they do in the case of other financial instruments not regulated under the Act. Similarly, the risk assessment recordkeeping and reporting requirements imposed on futures commission merchants by new section 4f(c) of the Act apply to the swap agreement activities of their affiliated persons.

n 14 See also footnote 12, *supra*.

n 15 As part of its ongoing review of its regulations, the Commission is considering revisions to Commission Rule 1.19. Suggestions by some commenters that Rule 1.19 should not be applicable to exempted swap agreements will be considered as part of this review.

In adopting part 35, it is the intention of the Commission to exempt from regulation (to the full extent permissible by the Act) all swap agreements which satisfy the requirements of the rule and which may otherwise be subject to regulation under the Act.

B. Definition of Swap Agreement

Rule 35.1(b)(1) adopts the definition of "swap agreement" incorporated into new section 4(c)(5)(B) and specifically set forth in 11 U.S.C. 101(55). Although one commenter thought the definition was too restrictive and several encouraged broader application, the majority of those who commented on the use of this definition stated their support for its adoption. This definition reflects Congressional intent that the Commission endeavor to give legal certainty to swap agreements with differing economic and financial characteristics. In addition, as noted by one commenter, the use of the same definition that is used in the Bankruptcy Code will help to create greater certainty in the marketplace for swaps, given the extent to which market certainty has been enhanced by the exemption of "swap agreements" (as defined in the Bankruptcy Code) from the automatic stay and other provisions of the Bankruptcy Code. The definition reflects the diversity and evolving nature of swap transactions in the marketplace. n16 The Commission believes the terms and conditions of Rule 35.2 adequately limit the scope of activity permitted under the exemption.

n 16 The words "any similar agreement" in the definition includes any agreement with a similar structure to those transactions expressly included in the definition (e.g., a cap, collar, or floor) without regard to the nature of the underlying commodity interest involved.

C. Eligible Swap Participants

Most commenters suggested various modifications to the proposed definition of "appropriate person." The Commission has considered these comments and the final rule reflects the changes discussed below. In addition, in order to avoid confusion with the use in section 4(c)(3) of the Act of the phrase "appropriate person," the final rule substitutes the phrase "eligible swap participant." No substantive change is intended by this new phrase.

In the Proposal, the Commission generally used the list of "appropriate persons" set forth in new section 4(c)(3) (A) through (J) and utilized the authority granted by section 4(c)(3)(K) to determine other persons to be "appropriate persons" provided that a natural person would only qualify to the extent his or her net worth exceeds \$5 million or total assets exceed \$10 million. This approach is consistent with Congressional intent that the Commission may limit the terms of an exemption to some, but not all, of the listed categories of appropriate persons. n17

n 17 H.R. Rep. No. 978, 102d Cong., 2d Sess. 79 (1992).

In defining "eligible swap participant" in the final rule, the basic list is retained but is refined to clarify issues raised by the commenters. As the Act specifies that the swap agreement may only be "entered into" by appropriate persons, this determination is to be made at the inception of the transaction. n18 Further, it is sufficient that the parties have a reasonable basis to believe that the other party is an eligible swap participant at such time. n19

n 18 There is no requirement that a swap agreement be terminated if an eligible swap participant no longer qualifies as such. However, in order to permit the orderly winding-down of the positions of counterparties undergoing financial or other distress, an eligible swap participant may enter into a "closing transaction" with a counterparty even if the counterparty no longer qualifies as an eligible swap participant, provided however, that such closing transaction terminates all obligations between the counterparties to the swap. Under this circumstance, the Commission will consider such non-qualifying counterparty an "eligible swap participant" solely for the purpose of terminating any outstanding swap agreements.

n 19 An eligible swap participant that has a reasonable basis to believe its counterparty is also an eligible swap participant when it enters into a master agreement may rely on such representation continuing, absent information to the contrary.

Many commenters noted the international scope of the swaps market. While most of the categories of eligible swap participants are not limited to U.S. persons, subsections (iv), (v), (vii), (ix), and (x) of proposed Rule 35.1(b)(2) reference persons regulated under the United States law applicable to each. Thus, these references exclude regulated foreign persons performing similar roles in their home jurisdictions. Consistent with the policy reflected in section 4(c)(3)(K), the Commission believes that regulated foreign persons are "appropriate persons" and has modified these subsections of the final rule to include such persons as "eligible swap participants." n20

n 20 The Commission considered comments that all non-United States persons be included in the definition of "eligible swap participant." However, as most categories of eligible swap participants are not limited to U.S. persons, this change accomplishes much the same result without favoring foreign participants over United States participants.

The eligible swap participant must be acting on its own behalf or on behalf of another eligible swap participant as a counterparty in order to qualify under the Rule. A conforming change to Rule 35.1(b)(2)(i) has therefore been made. In most circumstances, the Commission will not "look through" eligible swap participants to their investors to apply the qualifications of Rule 35.1(b)(2) again. However, investment companies, commodity pools or entities which are collective investment vehicles formed solely for the specific purpose of constituting an eligible swap participant to enter into swap agreements will not be considered eligible swap participants [*5590] under the exemption. Conforming changes to Rule 35.1(b)(2) have been made to make this clear.

In the Proposal the Commission requested specific comment regarding the net worth and asset tests for "appropriate persons." A number of commenters indicated that the financial thresholds should be lower, particularly for individuals (for example, that the "accredited investor" threshold of Rule 501 under the Securities Act of 1933 be used), and that no financial thresholds should be imposed on individuals who are otherwise registered and regulated under the Act or the Securities Exchange Act of 1934 (such as broker-dealers, futures commission merchants, commodity trading advisors, and investment advisers). n21 Others noted the lower thresholds applicable to partnerships, corporations, or proprietorships under proposed Rule 35.1(b)(2)(vi). At least one commenter indicated that the proposed list of appropriate persons went beyond the existing market.

n 21 The Futures Exchanges Letter suggested that the financial threshold for natural person floor traders and floor brokers be eliminated if such person's activities are guaranteed by a clearing member. Although the Commission has declined to make this change, it has added an alternative test for proprietorships as described above.

These financial thresholds are applied as an indication of financial sophistication and background. No commenters suggested that the proposed financial thresholds would adversely affect the market as conducted today, and on further consideration the Commission has determined to alter the financial tests for corporations and other entities, employee benefit plans and natural persons and to require commodity pools to have assets of at least \$5,000,000.

In the final rule the Commission has increased the financial threshold tests for entities specified in Rule 35.1(b)(2)(vi) and natural persons to \$10 million in total assets, and eliminated the net worth threshold. The Commission has added an alternative test for entities specified in Rule 35.1(b)(2)(vi) having net worth of at least \$1 million and which enter into the swap agreement in connection with their businesses or to manage the risk of an asset or liability owned or incurred in the conduct of their businesses or reasonably likely to be owned or incurred in the conduct of their businesses. n22 Finally, the Commission has increased the asset test for employee benefit plans to \$5,000,000.

n 22 To avoid uncertainty in the application of Rule 35.1(b)(2)(vi), the Commission is deleting reference to "business" before "entities" in this subsection. In addition, based upon comments received, the Commission has added credit unions to 35.1(b)(2)(ii) and made minor clarifying changes to subsections (vi) and (vii). Some commenters requested that the Commission specifically list entities, such as

501(c)(3) organizations under the Internal Revenue Code, in subsection (viii). The Commission believes such entities are contained within this subsection, and such specificity is unnecessary.

D. Other Conditions

In addition to the condition that the swap agreement be entered into solely between eligible swap participants as specified in Rule 35.2(a), the final rule imposes three further conditions. n23

n 23 The Futures Exchanges Letter proposes that the Commission add as a condition to the exemption that a self-regulatory organization ("SRO") be established to govern the swap market. Although couched in terms of the benefits of self-regulation, the objective underlying this proposal is revealed by the exchanges' statement that "(b)y the time the exchanges are ready to compete effectively * * * the dealers should have made and effectuated their SRO selection." Futures Exchanges Letter at 102. While it may be appropriate in some circumstances or for other reasons to condition an exemption on the existence or establishment of an SRO, the Commission declines to so condition this exemption and thus delay its implementation.

First, as specified by section 4(c)(5) of the Act, Rule 35.2(b) provides that swap agreements may not be part of a fungible class of agreements that are standardized as to their material economic terms. n24 This condition is designed to assure that the exemption does not encompass the establishment of a market in swap agreements, the terms of which are fixed and are not subject to negotiation, that functions essentially in the same manner as an exchange but for the bilateral execution of transactions. n25 Standardization of material economic terms is a necessary, but not sufficient, condition for fungibility, as other factors, such as individual negotiation of other material terms or counterparty credit risk also affect fungibility. n26 As a result of, for example, the existence of common conventions in related markets or the hedging of risks incident to common assets or liabilities, a swap agreement may have the same economic terms but yet not be one of a fungible class of standardized agreements. For example, parties hedging the same or similar asset, such as a five year bond with semi-annual interest coupons, may individually negotiate the same economic terms to match cash flows, yet negotiate other terms and conditions, including the consideration of the creditworthiness of the counterparty.

n 24 The phrase "material economic terms" is intended to encompass terms that define the rights and obligations of the parties under the swap agreement and that, as a result, may affect the value of the swap at origination or thereafter. Examples of such terms may include notional amount, amortization, maturity, payment dates, fixed and floating rates or prices (including the methods by which such rates or prices may be determined), payment computation methodologies, and any rights to adjust any of the foregoing.

n 25 The Futures Exchanges Letter questions the use of this condition and, in particular, one of the Commission's explanations of its purpose. Futures Exchanges Letter at 70-78. Distilled to its essence, the exchanges argue that the Commission's explanation is ambiguous because some swap agreements are as standardized as exchange traded futures, and that a swaps market which functions essentially as an exchange may exist today. The Commission does not find the purposes of this condition to be ambiguous as the exchanges assert. As to the assertion that some swap agreements are as standardized as exchange-traded futures contracts, this ignores the fact that most terms of exchange-traded futures contracts are set by the contract market, while all terms of swap agreements are subject to negotiation. As to the exchanges' other contention, a swaps market that today functions as an exchange would not be entitled to a part 35 exemption since the rule precludes exchange trading. See also Rule

35.2(d). Of course, what constitutes the "essential functions" of an "exchange" is subject to reasonable dispute but is generally left to an expert agency to decide. *Cf. Board of Trade versus Securities and Exchange Commission, 883 F.2d 525 (7th Cir. 1989).*

n 26 One commenter suggested that legal certainty would be increased if the Commission deleted 35.2(b) and stated that a swap agreement which is assignable and transferable only with counterparty consent and/or the obligations thereunder are terminable, absent default, only with counterparty consent, is not part of a fungible class of agreements that are standardized as to their material economic terms. While the Commission agrees that transferability is one indicia of fungibility, other facts or circumstances may also determine whether or not a swap agreement meets the requirements of Rule 35.2(b).

Standardization of terms that are not material economic terms, for example, definitions, representations and warranties, and default and remedies provisions, as found in certain forms and master agreements published by various associations, is not by itself violative of this requirement. n27 Moreover, a swap agreement would not be considered fungible or standardized simply because it is subject to a netting system or arrangement permitted under paragraph (d) of the rule provided the material economic terms of the swap agreement are subject to individual negotiation by the parties.

n 27 Standardization of these terms in published forms is not dissimilar to the standardization of terms for other areas, such as letters of credit. The publication of such standard terms facilitates communications and negotiations, but does not mean the provisions themselves are not subject to substantial negotiation.

Second, Rule 35.2(c) requires that the creditworthiness of any party having an actual or potential obligation under the swap agreement be a material consideration in entering into or determining the terms of the swap agreement including pricing, cost, or credit enhancement terms. n28 The [*5591] standard is intended to be objective, and does not require parties to actually negotiate (or demonstrate that they have negotiated) particular provisions. The clarifying phrase in the rule regarding "any party having an actual or potential future obligation" refers to obligations that create credit risk, not to ancillary obligations, such as obligations to deliver documents or perform (or refrain from performing) financial or business-related covenants. By this criterion, at this time, the exemption does not extend to transactions that are subject to a clearing system where the credit risk of individual members of the system to each other in a transaction to which each is a counterparty is effectively eliminated and replaced by a system of mutualized risk of loss that binds members generally whether or not they are counterparties to the original transaction. n29

n 28 The Futures Exchanges Letter asserted that the Commission's choice of certain conditions in the Proposal was an impermissible attempt to employ the criteria from the Senate version of the 1992 Act which had mandated a swap exemption. However, as enacted, section 4(c)(1) expressly empowers the Commission to grant exemptions on "stated terms or conditions." As the Conferees recognized, the Commission may impose conditions on the swaps exemption "beyond those of lack of fungibility and standardization." H. Rep. 978, 102 Cong., 2d Sess. at 82 (1992).

n 29 As recognized by the Futures Exchanges Letter, such a mutualized system would constitute a clearing system not unlike those employed by the exchanges. See also footnote 30, *infra*.

Based upon comments from futures exchanges and others, the Commission has revised the proviso to Rule 35.2(b) and (d) to clarify its meaning and to distinguish bilateral arrangements or facilities from multiparty arrangements or facilities. Under the proviso, bilateral arrangements for the netting of obligations to make payments or transfers of property, including margin or collateral, would be permitted. Multiparty netting arrangements would also be permitted, provided that the underlying gross obligations among the parties are not extinguished until all netted obligations are fully performed.

In addition, the "creditworthiness" condition is not intended to limit the ability of parties to undertake any bilateral collateral or margining arrangements to address credit issues. By expanding the ability of swap participants to utilize collateral and margin arrangements beyond that which is explicitly permitted under the Policy Statement, these rules should promote arrangements that will reduce risk within the financial system. n30

n 30 The Commission shares the goal of financial system risk reduction as expressed in the comment letters from the Department of the Treasury, the Board of Governors of the Federal Reserve System ("Board"), and Office of the Comptroller of the Currency ("OCC"). The Commission understands these comment letters to generally support the promulgation of part 35 but to express concern that Commission rules should go further to promote the reduction of systemic risk. In this regard, while the OCC and the Board endorsed the development of appropriately structured multilateral payment netting for swaps, the Board also observed that the Commission should permit multilateral settlement (or clearing) so risk of loss could be mutualized. The Commission believes that a clearing house system for swap agreements could be beneficial to participants and the public generally. However, as such mechanisms are not yet in existence, and may take many forms and raise different regulatory concerns depending upon their structure or participants or whether another regulatory regime is applicable, the Commission will consider the terms and conditions of such an exemption for swap clearing houses in the context of specific proposals from exchanges, other regulators, or others. The Commission has added a proviso to the final rule to make clear that in this regard any party may apply for exemptions from the Act and that the Commission will consider the terms and conditions that may be appropriate, including other applicable regulatory regimes. While not limiting exemptions to those conditioned upon another regulatory scheme (and not otherwise limiting the imposition of conditions) the Commission is mindful of the costs of duplicative regulation. The Commission intends to give market participants maximum latitude in developing multilateral mechanisms to control credit and settlement risk which may reduce systemic risk. The new proviso reflects the Commission's determination to encourage innovation in developing the most efficient and effective types of systemic risk reduction. The Commission has previously recognized the virtues of clearing systems that mutualize risk and do not believe that this Rule should disadvantage the development of such systems. The Commission believes that the design of swap clearing facilities and the services that the facility will offer should be driven by the needs and desires of swap market participants.

Third, Rule 35.2(d) provides that the swap agreement may not be entered into and traded on or through a multilateral transaction execution facility. In this context, a multilateral transaction execution facility is a physical or electronic facility in which all market makers and other participants that are members simultaneously have the ability to execute transactions and bind both parties by accepting offers which are made by one member and open to all members of the facility. This limitation is not intended to preclude participants from engaging in privately negotiated bilateral transactions, even where these participants use computer or other electronic facilities, such as "broker screens," to communicate simultaneously with

other participants so long as they do not use such systems to enter orders to execute transactions. n31 The Commission understands such facilities are in use today.

n 31 The Futures Exchanges Letter appears to confuse electronic and computer facilities which provide information to those having access to the facility, with physical or electronic facilities which allow participants to execute and trade instruments or contracts. A computer-based trading system for swap agreements is beyond the scope of these rules but may be the proper subject of the Commission's further exercise of its authority under section 4(c). See also footnote 30, *supra*.

The Commission believes that transaction execution facilities could provide important benefits in terms of increased liquidity and price transparency. However, as is the case with clearing facilities, transaction execution facilities for swap agreements are not yet in existence, and present different regulatory issues than are raised by the exemption provided by the final rule. Thus, transaction execution facilities are beyond the scope of part 35 as adopted today. Consistent with the proviso in the final rule, however, the Commission invites applications for appropriate exemptive relief for such facilities as they are developed.

E. Statutory Determinations

As stated above, section 4(c) requires that the Commission make a number of determinations in granting exemptions. n32 If an exemption is granted pursuant to section 4(c) from the requirements of section 4(a), the determinations are that the requirement of section 4(a) should not be applied to the agreement, contract, or transaction and that the exemption is (1) consistent with the public interest; (2) consistent with the purposes of the Act; and (3) the agreement, contract, or transaction "will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties" under the Act. n33 With regard to the exchange trading requirement of section 4(a), the swaps market presently exists outside the forum of exchange trading [*5592] and the Commission has determined that the requirement should not be applied to swap agreements meeting the conditions of the exemption. Indeed, one of the prerequisites for the exemption is that the swaps agreement not be standardized like exchange products or entered into or traded on a multilateral execution transaction facility. n34

n 32 Contrary to the contention of the Futures Exchanges Letter, the plain meaning of the statute requires only that the determinations be made when the exemption is granted, but not when an exemption is merely proposed. See section 4(c)(2). The four exchanges also contend that the Proposal violates the Administrative Procedure Act ("APA") by failing to provide, among other things, an opportunity for "meaningful comment." The APA requires that a notice of proposed rulemaking include "either the terms or substance of the proposed rule or a description of the subjects and issues involved." 5 U.S.C. 553(b). In this instance the Proposal met both tests: it not only provided a description of the subject issues involved, it set forth the full text of the proposed rule. Further, this APA provision has been interpreted by one court to mean that the notice should be of sufficient detail and rationale to permit parties to comment meaningfully. See, *Fertilizer Inst. v. EPA*, 935 F.2d 1302, 1310-11 (D.C. Cir. 1991). The numerous detailed comment letters received support the conclusion that an opportunity for meaningful comment was provided by the Proposal. Further, despite their protestations to the contrary, the four futures exchanges who filed in opposition (and, in particular, the 108-page Futures Exchanges Letter) appeared to be sufficiently informed of the Commission's rationale to comment "meaningfully" on the Proposal.

n 33 Section 4(c)(2), 7 U.S.C. 6(c)(2). This section also places a condition on an exemption from section 4(a) of the Act that the transaction will be entered into solely between appropriate persons. As discussed above, the Commission has made this a prerequisite for the swap agreement to qualify for exemption under Part 35.

n 34 See discussion above regarding Rule 35.2(c) and (d). See also H. Rep. No. 102-978, 102d Cong., 2d Sess. 80 (1992).

Public Interest and Purposes of the Act Determination

As is frequently the case when Congress grants a regulatory agency authority to act consistent with "the public interest and the purposes of" its enabling statute, little statutory elaboration is given to the full scope of the phrase. As commonly understood, however, an agency, such as the Commission, is to apply this standard against the template of its regulatory scheme. In this regard, the Conference Report states that the "public interest" under section 4(c) includes "the national public interests noted in the (Act), the prevention of fraud and the preservation of the financial integrity of markets, as well as the promotion of responsible economic or financial innovation and fair competition." H.R. Rep. No. 978, 102d Cong., 2d Sess. 78 (1992). n35 The Conference Report goes on to state that "(t)he Conferees intend for this reference to the 'purposes of the Act' to underscore their expectation that the Commission will assess the impact of a proposed exemption on the maintenance of the integrity and soundness of markets and market participants." *Id.*

n 35 The Futures Exchanges Letter notes that in addressing certain elements of the public interest for futures trading, Congress has indicated that contract market designation and regulation under the Act is necessary to avoid creating an undue burden on commerce. See section 3 of the Act. Seventy years after the enactment of section 3, however, Congress enacted section 4(c) authorizing exemptions from section 4(a) of the Act because "traditional futures regulation * * * may create an inappropriate burden on commerce." H.R. Rep. No. 978, 102d Cong., 2d Sess. 80 (1992).

Swap agreements are used by corporations, financial institutions, governments, governmental entities, and others, and are important tools that are used by these entities to hedge or manage financial risk and accomplish other financial objectives. In issuing this exemption, the legal risk (that the agreements would be unenforceable), and thus financial risk, is reduced within the financial markets and that legal certainty contributes to the preservation of the financial integrity of the markets. n36 By removing or reducing uncertainty, the final rule should promote innovation in the swaps market by allowing participants to negotiate and structure transactions that most effectively address their economic needs. n37

n 36 The Futures Exchanges Letter appears to say in several places that the Commission must find that the exemption provides legal certainty. While this is certainly a goal of the final rule, it is not a statutorily mandated finding which the Commission must make.

n 37 As noted in several comment letters, including comments from federal regulators, permitting mark-to-market margin and collateral and multiparty payment netting systems reduces financial risk and encourages responsible economic innovation.

Further, the exemption will assist United States financial institutions to compete with foreign rivals in the highly competitive market for swaps by removing a regulatory uncertainty with respect to the market in the United States that has not been present in most other major financial and industrial countries. In this regard, the exchanges' comment that "fair competition" under section 4(c) means that the rule as finalized must permit the exchanges to conduct a swaps market in their own manner

is without merit. Exchanges and their members are not excluded from these rules, however, and may participate in swap agreements on the same terms and conditions that apply to all other eligible swaps participants. n38

n 38 In considering fair competition, Congress expected that "the Commission will apply consistent standards based on the underlying facts and circumstances of the transaction and markets being considered and may make distinctions between exchanges and other markets, taking into account the particular facts and circumstances involved * * * where such distinctions are not arbitrary and capricious." H.R. Rep. No. 978, 102d Cong., 2d Sess. 78 (1992).

Material Adverse Effect on Regulatory or Self-Regulatory Responsibilities

In making this determination, Congress indicated that the Commission is to consider such regulatory concerns as "market surveillance, financial integrity of participants, protection of customers and trade practice enforcement." n39

n 39 H.R. Rep. No. 978, 102d Cong., 2d Sess. 79 (1992).

The record before the Commission does not support a conclusion that the purposes of the Act or the Commission's regulatory efforts thereunder have been adversely affected by the swaps market or will be so affected by the issuance of this exemption. Swap transactions have been entered into by a variety of participants for more than a decade, and the number of defaults appears to be low. n40 Nor do allegations of fraud appear to be an issue in this market. The Commission has addressed concerns regarding financial integrity and customer protection through the requirement that swaps only be entered into between eligible swap participants and that, as provided in Rule 35.2(b), creditworthiness of the parties be a material consideration. This approach precludes anonymous transactions and ensures that swap agreements will be limited to those persons who are sophisticated or financially able to bear risks associated with the transactions. n41

n 40 Azarchs, "Banks Face Manageable Risks in Derivative Businesses," Standard & Poors Credit Week, November 1992.

n 41 In enacting the 1992 Act, Congress explicitly authorized exemptions from all provisions of the Act (except 2(a)(1)(B)) and simultaneously enacted a "conforming amendment" to 12(e)(2) explicitly acknowledging that state antifraud statutes of general applicability would continue to apply to exempted transactions. See also footnote 12, *supra*.

The Commission also notes that the existence of the swap market, which by any measurement (*e.g.*, total notional amount at year end 1991 of \$4 trillion) has not to date affected the ability of the futures exchanges to fulfill their self-regulatory duties. n42 It is widely acknowledged that the futures market and the swap market are linked, with swap market participants using certain exchange traded futures as hedging vehicles. n43 By creating a more certain legal environment for swaps, the potential for systemic risk is reduced, and there is no reason to conclude that the exchanges' self-regulatory responsibilities will be adversely affected by permitting the swaps market to continue on this basis. n44

n 42 Indeed, in their lengthy submissions, the futures exchanges do not claim that approval of the Proposal will adversely affect their self-regulatory responsibilities.

n 43 See, *e.g.*, Thompson, "Oil Swaps, A Potential Source of New Business for NYMEX," Futures Industry, November-December 1992.

n 44 The Commission is unaware of any swap agreements that provide for settlement by tendering a delivery instrument, such as an exchange-approved warehouse receipt or shipping certificate, that is specified in the rules of a designated contract market. Swap agreements of this kind could have an effect upon deliverable supplies for settlement of designated futures or option contracts and, accordingly, the creation of such agreements should occur only after consultation with the Commission.

Anticompetitive Considerations

Section 15 of the Act provides, in relevant part, that the Commission must consider the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives, policies, and purposes of the Act in adopting any rule, regulation, or exemption under section 4(c). n45 Thus, a [*5593] formal analysis under the antitrust laws is not, by itself, dispositive of the issues raised by a rule. n46 As a result, the Commission is not compelled by section 15 to take the least anticompetitive course of action. Rather, where alternatives with varying degrees of regulatory benefit exist, the Commission may adopt the approach that appears to be most likely to achieve the objectives, policies, and purposes of the Act, even if that approach is not the least anticompetitive. n47

n 45 Specifically section 15, as amended by section 502(b) of the 1992 Act, provides: The Commission shall take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of this Act, as well as the policies and purposes of this Act, in issuing any order or adopting any Commission rule or regulation (including any exemption under sections 4(c) or 4c(b)), or in requiring or approving any bylaw, rule, or regulation of a contract market or registered futures association established pursuant to section 17 of this Act.

n 46 See *Gordon v. New York Stock Exchange*, 422 U.S. 659, 690-691 (1975); *Silver v. New York Stock Exchange*, 373 U.S. 341 (1963).

n 47 See, e.g., *British American Commodity Options Corp. v. Bagley*, *Comm. Fut. L. Rep. (CCH) para. 20,245 at 21,334 (S.D.N.Y. 1976)*, *aff'd in part and rev'd in part*, 552 F.2d 482 (2d Cir. 1977), *cert. denied*, 98 S.Ct. 427 (1977).

Accordingly, section 15 requires the Commission to balance the likely anti-competitive impact of adopting a rule against the objective, policy, or purpose of the Act which the rule may further. And, although the Commission must consider the public interest in maintaining or promoting competition, it need not weigh this interest equally against an objective, policy, or purpose of the Act being served by a rule in reaching its final determination concerning the adoption of the rule.

The Commission's consideration of the proposed rule and its evaluation of the comments received in this regard has led it to conclude that any possible anti-competitive effects are clearly outweighed by the rule's furtherance of the policies, purposes, and objectives of the Act for the following reasons.

First, the proposal does not appear to raise any significant competitive issues. As several commenters noted, the exemption, by improving the legal certainty of the market for swap agreements, will increase growth, innovation, and competition in this market. Competition, in particular, will be promoted because of the flexibility provided by the exemption concerning persons who may appropriately enter swap transactions. In this regard, in addition to those now participating in swap transactions under the Commission's Policy Statement, the exemption would allow other persons, including futures exchanges or affiliates thereof, to engage in swap transactions on the same basis as all other participants. n48

n 48 The Futures Exchanges Letter argues that the exemption, because it does not permit exchange trading of the swap agreements being exempted, promotes unfair competition. As is noted above, however, the exchanges (or their affiliates) remain free to compete under the final rules on an equal footing with all other eligible swap participants.

Second, the exemption furthers a fundamental objective of the Act, i.e., implementing new section 4(c)(5)(B) of the Act, which authorizes the Commission to exercise "promptly" its exemptive authority concerning swap agreements of the kind described therein. In this regard, the Conference Report on the 1992 Act notes that "the Conferees expect and strongly encourage the Commission to use its new exemptive powers promptly upon enactment in * * * areas where significant concerns of legal uncertainty have arisen (including) * * * swap * * *." n49 The Commission believes that the exemption adopted herein is responsive to these Congressional concerns and is properly circumscribed in accordance with the criteria set forth in the 1992 Act.

n 49 H.R. Rep. No. 978, 102d Cong., 2d Sess. 81 (1992).

Finally, the Commission is unaware of any anticompetitive practices or other discernible adverse effects arising during the evolution and development of the swaps market, particularly as the market has developed in reliance on its Swaps Policy Statement. It is therefore reasonable to expect that the exemption will be similarly devoid of adverse effects on competition.

In conclusion, the part 35 rules as set forth below and adopted herein are supported by appropriate determinations made in accordance with the standards set forth in section 4(c) of the Act for the granting of exemptions.

F. Future Exemptive Relief

The Commission will, consistent with section 4(c), consider further exemptive relief on its own initiative or upon application by any person (including futures exchanges) for agreements, transactions, or contracts (including classes thereof) not addressed in this rule. To the extent that market participants wish to use or establish a multilateral transaction execution facility for swap transactions, or clearing systems involving mutualized risk or multiparty netting of payment obligations, the Commission will evaluate the terms and conditions, if any, that would be appropriate under section 4(c) of the Act in connection with any request for exemptive relief involving such a facility.

II. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA"), Public Law No. 96-354, 94 Stat. 1164 (1980), 5 U.S.C. 601 et seq., requires each federal agency to consider, in the course of proposing substantive rules, the effect of those rules on small entities. A small entity is defined to include, *inter alia*, a "small business" and a "small organization." 5 U.S.C. 601(6). n50 The Commission previously has formulated its own standards of what constitutes a small business with respect to the types of entities regulated by it. The Commission has determined that contract markets, n51 futures commission merchants, n52 registered commodity pool operators, n53 and large traders n54 should not be considered small entities for purposes of the RFA.

n 50 "Small organizations," as used in the RFA, means "any not-for-profit enterprise which is independently owned and operated and is not dominant in its field * * *" 5 U.S.C. 601(4). The RFA does not incorporate the size standards of the Small Business Administration ("SBA") for small organizations. Agencies are expressly authorized to establish their own definition of small organization. *Id.*

n 51 47 FR 18618 (April 30, 1982).

n 52 *Id.* at 18619.

n 53 *Id.*

n 54 *Id.* at 18620.

The Commission continues to believe that it is unlikely that firms defined as small businesses under section 3 of the Small Business Act could offer or be offered swap agreements and thus be affected by the proposed rule exempting such agreements. Further, the proposed rule would not add any legal, accounting, consulting, or expert costs but rather would broaden the categories of permissible products sold other than on designated exchanges. The determination of whether a swap agreement would qualify for the proposed exemption requires minimal analysis of data that will be readily accessible to the offeror.

No comments were received with respect to the RFA implications of new part 35.

B. Paperwork Reduction Act

The Paperwork Reduction Act of 1989 ("PRA"), 44 U.S.C. 3501 et seq., imposes certain requirements on federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information as defined by the PRA. As the Commission noted in proposing part 35, it has determined that proposed part 35 does not impose any information [*5594] collection requirements as defined by the PRA. No comments were received concerning the Commission's determination in this regard.

List of Subjects in 17 CFR Part 35

Commodity futures, Commodity options, Prohibited transactions.

In consideration of the foregoing, and pursuant to the authority contained in the Commodity Exchange Act, and in particular, sections 2, 4, 4c, and 8a, 7 U.S.C. 2, 6, 6c, and 12a, as amended, the Commission hereby adds part 35 of chapter I of title 17 of the Code of Federal Regulations as follows:

PART 35 -- EXEMPTION OF SWAP AGREEMENTS

Sec.

35.1 Definitions.

35.2 Exemption.

Authority: 7 U.S.C. 2, 6, 6c, and 12a.

§ 35.1 Definitions

(a) *Scope.* The provisions of this part shall apply to any swap agreement which may be subject to the Act, and which has been entered into on or after October 23, 1974.

(b) *Definitions.* As used in this part:

(1) *Swap agreement* means:

(i) An agreement (including terms and conditions incorporated by reference therein) which is a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency

rate swap agreement, currency option, any other similar agreement (including any option to enter into any of the foregoing);

(ii) Any combination of the foregoing; or

(iii) A master agreement for any of the foregoing together with all supplements thereto.

(2) *Eligible swap participant* means, and shall be limited to the following persons or classes of persons:

(i) A bank or trust company (acting on its own behalf or on behalf of another eligible swap participant);

(ii) A savings association or credit union;

(iii) An insurance company;

(iv) An investment company subject to regulation under the Investment Company Act of 1940 (*15 U.S.C. 80a-1 et seq.*) or a foreign person performing a similar role or function subject as such to foreign regulation, *provided* that such investment company or foreign person is not formed solely for the specific purpose of constituting an eligible swap participant;

(v) A commodity pool formed and operated by a person subject to regulation under the Act or a foreign person performing a similar role or function subject as such to foreign regulation, *provided* that such commodity pool or foreign person is not formed solely for the specific purpose of constituting an eligible swap participant and has total assets exceeding \$5,000,000;

(vi) A corporation, partnership, proprietorship, organization, trust, or other entity not formed solely for the specific purpose of constituting an eligible swap participant (A) which has total assets exceeding \$10,000,000, or (B) the obligations of which under the swap agreement are guaranteed or otherwise supported by a letter of credit or keepwell, support, or other agreement by any such entity referenced in this paragraph (b)(2)(vi)(A) of this section or by an entity referred to in paragraph (b)(2) (i), (ii), (iii), (iv), (v), (vi) or (viii) of this section; or (C) which has a net worth of \$1,000,000 and enters into the swap agreement in connection with the conduct of its business; or which has a net worth of \$1,000,000 and enters into the swap agreement to manage the risk of an asset or liability owned or incurred in the conduct of its business or reasonably likely to be owned or incurred in the conduct of its business;

(vii) An employee benefit plan subject to the Employee Retirement Income Security Act of 1974 or a foreign person performing a similar role or function subject as such to foreign regulation with total assets exceeding \$5,000,000, or whose investment decisions are made by a bank, trust company, insurance company, investment adviser subject to regulation under the Investment Advisers Act of 1940 (*15 U.S.C. 80a-1 et seq.*), or a commodity trading adviser subject to regulation under the Act;

(viii) Any governmental entity (including the United States, any state, or any foreign government) or political subdivision thereof, or any multinational or supranational entity or any instrumentality, agency, or department of any of the foregoing;

(ix) A broker-dealer subject to regulation under the Securities Exchange Act of 1934 (*15 U.S.C. 78a et seq.*) or a foreign person performing a similar role or function subject as such to foreign regulation, acting on its own behalf or on behalf of another eligible swap participant: *Provided, however,* that if such broker-dealer is a natural person or proprietorship, the broker-dealer must also meet the requirements of either paragraph (b)(2) (vi) or (xi) of this section;

(x) A futures commission merchant, floor broker, or floor trader subject to regulation under the Act or a foreign person performing a similar role or function subject as such to foreign regulation, acting on its own behalf or on behalf of another eligible swap participant: *Provided, however,* that if such futures commission merchant, floor broker, or floor trader is a natural person or proprietorship, the futures commission merchant, floor broker, or floor trader must also meet the requirements of paragraph (b)(2) (vi) or (xi) of this section; or

(xi) Any natural person with total assets exceeding at least \$10,000,000.

§ 35.2 Exemption.

A swap agreement is exempt from all provisions of the Act and any person or class of persons offering, entering into, rendering advice, or rendering other services with respect to such agreement, is exempt for such activity from all provisions of the Act (except in each case the provisions of sections 2(a)(1)(B), 4b, and 4o of the Act and § 32.9 of this chapter as adopted under section 4c(b) of the Act, and the provisions of sections 6(c) and 9(a)(2) of the Act to the extent these provisions prohibit manipulation of the market price of any commodity in interstate commerce or for future delivery on or subject to the rules of any contract market), provided the following terms and conditions are met:

(a) The swap agreement is entered into solely between eligible swap participants at the time such persons enter into the swap agreement;

(b) The swap agreement is not part of a fungible class of agreements that are standardized as to their material economic terms;

(c) The creditworthiness of any party having an actual or potential obligation under the swap agreement would be a material consideration in entering into or determining the terms of the swap agreement, including pricing, cost, or credit enhancement terms of the swap agreement; and

(d) The swap agreement is not entered into and traded on or through a multilateral transaction execution facility;

provided, however, that paragraphs (b) and (d) of Rule 35.2 shall not be deemed to preclude arrangements or facilities between parties to swap agreements, that provide for netting of payment obligations resulting from such swap agreements nor shall these subsections be deemed to preclude arrangements or facilities among parties to swap agreements, that provide for netting of payments resulting from such swap [*5595] agreements; *provided further,* that any person may apply to the Commission for exemption from any of the provisions of the Act (except 2(a)(1)(B)) for other arrangements or facilities, on such terms and conditions as the Commission deems appropriate, including but not limited thereto, the applicability of other regulatory regimes.

Issued in Washington, DC on January 14, 1993, by the Commission.

Jean A. Webb,

Secretary of the Commission.

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