Congressional Research Service

Report RS20560

The Commodity Futures Modernization Act (P.L. 106-554)

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February 3, 2003

Abstract. The last act of the 106th Congress was to pass an omnibus bill that included the Commodity Futures Modernization Act (H.R. 5660; P.L. 106-554), the most significant amendments to the regulation of derivatives trading in 25 years. Derivative financial instruments are those that gain or lose value as some underlying rate, price, or other economic variable changes. Derivatives traders can speculate on future trends in financial assets (such as stocks or currencies) or commodities (oil, metals, pork bellies) without actually owning the underlying items. Derivatives may be employed to reduce financial risk or in risky speculation on future prices and rates. These contracts do not fit in the jurisdictional boxes of financial regulation, and inter-agency quarrels have occurred over the years. The 106th Congress approved an overhaul of derivatives regulation which codified the unregulated status of certain derivatives, permitted the exemption of other currently-regulated contracts from oversight by the Commodity Futures Trading Commission (CFTC), and permitted the trading of a new kind of contract: a futures contract/security hybrid based on the stocks of individual corporation.

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Congressional Research Service
7-5700
www.crs.gov
RS20560

CRS Report for Congress
Prepared for Members and Committees of Congress

Summary

The last act of the 106th Congress was to pass an omnibus bill that included the Commodity Futures Modernization Act (H.R. 5660; P.L. 106-554), the most significant amendments to the regulation of derivatives trading in 25 years. Derivative financial instruments are those that gain or lose value as some underlying rate, price, or other economic variable changes. Derivatives traders can speculate on future trends in financial assets (such as stocks or currencies) or commodities (oil, metals, pork bellies) without actually owning the underlying items. Derivatives may be employed to reduce financial risk or in risky speculation on future prices and rates. These contracts do not fit in the jurisdictional boxes of financial regulation, and inter-agency quarrels have occurred over the years. The 106th Congress approved an overhaul of derivatives regulation which codified the unregulated status of certain derivatives, permitted the exemption of other currently-regulated contracts from oversight by the Commodity Futures Trading Commission (CFTC), and permitted the trading of a new kind of contract: a futures contract/security hybrid based on the stocks of individual corporation. This report will not be updated further. Developments in derivatives regulation will be tracked in CRS Report RS21401, *Regulation of Energy Derivatives*.

Contents

Contacts

The Commodity Futures Modernization Act of 2000 (CFMA) enacted the most sweeping amendments to derivatives law since the creation of the Commodity Futures Trading Commission (CFTC) in 1974. Provisions included major changes in the Commodity Exchange Act (CEA) regarding the regulation of exchange-traded futures contracts, over-the-counter (OTC) derivatives, and "security futures," contracts based on individual stocks (which were previously prohibited).

The CFMA's provisions generally followed the recommendations contained in a November 1999 report by the President's Working Group on Financial Markets, which consists of the Federal Reserve, the Treasury, the Securities and Exchange Commission (SEC), and the CFTC.[1] The principal recommendations of the report were as follows:

- to remove uncertainty about the legal and regulatory status of over-the-counter (OTC) derivatives, bilateral transactions between sophisticated parties that do not involve non-financial commodities with finite supplies should be excluded from the Commodity Exchange Act (CEA); that is, the CFTC should have no jurisdiction;
- the OTC derivatives markets should be allowed to adopt features of the CFTC-regulated, exchange-based derivatives marketplace, such as exchange trading and clearing houses; and
- exchange-traded futures and options that are not sold to small public investors and that are based on financial variables (as opposed to physical commodities with finite supplies, considered more susceptible to price manipulation) may not require regulation under the Commodity Exchange Act. The act should therefore be amended to let the CFTC exempt financial futures and options from much of current regulation.[2]

Apart from its substance, the Working Group's report was remarkable in that the four agencies, which had a history of jurisdictional quarrels, unanimously agreed on a redrawing of the regulatory lines. The CFMA was shaped significantly by the Working Group's report, although it differed in certain important aspects. The major provisions of the CFMA are discussed below.

Legal Certainty for Swaps and Off-exchange Derivatives

A long-standing question in derivatives regulation was whether the Commodity Exchange Act applied to contracts that were not traded on futures exchanges. A plain reading of the pre-2000 law suggests that it did: in 1974, Congress gave the CFTC exclusive jurisdiction over all contracts "in the character of" futures contracts, and mandated that such contracts, with certain exceptions, should only be traded on CFTC-regulated exchanges.

[1] *Over-the-Counter Derivatives Markets and the Commodity Exchange Act: Report of the President's Working Group on Financial Markets.* November 1999. 35 p.

[2] For background on these and related issues, see CRS Report RL30434, *The Commodity Futures Modernization Act of 2000: Derivatives Regulation Reconsidered.*

However, in the 1980s, an off-exchange market in derivatives grew up. The major dealers in this OTC market were banks and securities firms, and the principal instrument was the swap contract. Although swaps are clearly "in the character of" futures contracts – they serve the same economic purposes and are often interchangeable – the CFTC did not move to assert its jurisdiction. The CEA's exclusivity provisions remained, however, and were seen as a source of "legal risk" to the swaps market. That is, if a court had ruled that swaps were in fact illegal, off-exchange futures contracts, trillions of dollars in OTC derivative contracts might have been rendered void and unenforceable.

The CFMA specifies that the CEA does not apply to contracts between "eligible contract participants" (which include financial institutions, regulated financial professionals, units of government, nonfinancial businesses or individual persons with assets over $10 million, and others whom the CFTC may approve) based on "excluded commodities," defined as financial products and indicators (which are thought to be less susceptible to manipulation than physical commodities with finite supplies).

Derivatives based on agricultural commodities, however, may be traded only on CFTC-regulated exchanges, because of concerns about price manipulation – "corners" and "squeezes"– in those markets.

The CFMA creates a third group of "exempt commodities," which includes all commodities that are neither financial nor agricultural. (In today's markets, these are primarily metals and energy products, but derivatives introduced in the future will fall into the "exempt" category as well.) OTC derivatives in exempt commodities may be traded by eligible contract participants without CFTC regulation, except that certain provisions in the CEA against fraud and manipulation apply to these markets.

The CFTC continues to have jurisdiction over exchange-traded futures contracts based on either excluded (financial) or exempt (other nonagricultural) commodities. There are active markets in both exchange-traded and OTC derivatives based on financial and energy products.

While the Working Group's report did not envision a "retail" swaps market, in which small investors could participate, the creation of such a market was considered by Congress. Section 22 of S. 2697 (as introduced) directed the President's Working Group to prepare a report on the possibility of marketing swaps to individuals. H.R. 4541, as reported by the House Banking Committee, directed bank regulators to draft rules that would permit the establishment of a retail swaps market. The version of H.R. 4541 passed by the House did not include such provisions. The CFMA as enacted directed regulators to study the issue. The Working Group issued a report in December 2001, finding that there was no commercial interest in buying or selling retail swaps, and therefore no need for Congress to establish a regulatory framework.

Exchange Trading and Clearing of Swaps

Exchange Trading

In 1993, the CFTC addressed the issue of legal uncertainty by issuing regulations exempting financial swaps, a form of OTC derivatives, from the CEA. (A separate exemption permitted trading of certain OTC contracts based on energy products outside the CEA.) Under the swaps exemption, swaps were not considered futures (subject to the exchange trading requirement and other CFTC regulations) as long as they met several conditions that distinguished them from exchange-traded contracts. Among the conditions was a requirement that swaps must be bilaterally negotiated agreements and not traded on an exchange or exchange-like facility open to multiple buyers and sellers.

However, in the late 1990s there was interest in creating multilateral swaps exchanges, and at least one such facility began operations. An exchange, where bids and offers would be exposed to a large number of market participants, could bring more liquidity to the swap market, and make price information more widely available, allowing businesses and others to manage their financial risks more efficiently and economically.

The CFMA permits the use of exchange-like electronic facilities for the trading of OTC derivatives based on excluded (financial) commodities. OTC electronic trading facilities are also permitted for the exempt commodities (energy, minerals, etc.), with some CFTC oversight.

Clearing Houses

The 1993 exemption removed swaps from CEA regulation so long as contracts were not guaranteed by a centralized clearing house (as exchange-traded futures and options are). In other words, to qualify for the exemption, each party to a swap had to bear the risk of the opposite party's default. A clearing house – where a number of dealers guarantee all contracts and collectively assume the risk of default – could increase confidence in the market, and reduce the risk that the failure of a single large swap dealer would have repercussions throughout the financial system. As in the case of swaps exchanges, many market participants feel that clearing houses would be beneficial to the market.

The CFMA provides for the establishment of clearing houses for OTC derivatives, establishes certain regulatory requirements for them, and allows their operators to choose whether to be regulated by the CFTC, the SEC, or a banking regulator. In the two years following enactment of the CFMA, neither exchanges nor clearing houses have supplanted to any major degree the existing dealer market structure.

Deregulation of Exchange-based Futures Trading

The pre-2000 Commodity Exchange Act provided for a uniform, one-size-fits-all system of regulation of futures trading. By and large, institutional and professional trades were regulated the same as trades involving small public customers, and it made no difference whether the underlying commodity was corn, natural gas, or an interest rate. The CFMA replaces this uniform system with a three-tiered system of regulation. The CFMA authorizes registered futures exchanges to create two new types of markets, which would be subject to less regulation (or virtually no regulation) depending on who is allowed to trade. Thus, there are now three types of futures market permitted by law.

First are the markets designated as *contract markets.* Contract markets are subject to generally the same degree of regulation as pre-2000 futures exchanges. To qualify for contract market status, an exchange must follow 17 core principles to maintain fair, open, and competitive markets.

Contracts based on agricultural commodities and trades involving retail customers are generally confined by the CFMA to markets of this type.

Second, the exchanges may establish *derivatives transaction execution facilities*. These DTEFs could offer only contracts based on commodities whose deliverable supply was "nearly inexhaustible," where manipulation was "highly unlikely," or where there was no underlying cash market (as in certain financial indicators, rates, or ratios). In addition, eligible traders would be limited to eligible contract participants and to others who traded through a futures commission merchant, or broker, that belonged to a clearing house and had net capital of at least $20 million. DTEFs must register with the CFTC, but the degree of regulation would be less stringent and comprehensive than that applicable to contract markets – 8 core regulatory principles apply, rather than 17.

Third and finally, the CFMA provides that a market where all contracts are based on excluded commodities and where *all* traders, including brokers' customers, are eligible contract participants, can be an *exempt board of trade*. Exempt boards would not have to register with the CFTC at all, and would be exempt from all provisions of the CEA, except for anti-fraud and manipulation rules. However, if the CFTC determines that an exempt board has become a significant source of price discovery (that is, if this derivatives market sets prices in the underlying cash market), it can require the board to disclose daily trading data.

As of early 2003, the exchanges have not moved to create exempt boards of trade or DTEFs. In other words, futures trading continues much as it was before the CFMA.

Futures Contracts on Single Stocks

The 1982 Shad/Johnson agreement divided regulatory jurisdiction over futures and options based on securities and stock indexes between the CFTC and the Securities and Exchange Commission (SEC). One provision of Shad/Johnson is a ban on futures contracts based on single stocks. H.R. 4541 as introduced permitted such contracts to be traded on futures exchanges with certain restrictions. The CFTC was to be the primary regulator, but was required to consult with the SEC before approving single-stock contracts, and the SEC was to receive price, volume, and other market data. The SEC would have had enforcement authority regarding insider trading, price manipulation, and other violations of the securities laws that might involve futures on single stocks. Finally, the Federal Reserve would have authority to set margins for single-stock futures (as it does for stock index futures and stocks themselves), but could delegate this authority to an intermarket board including the CFTC and the SEC.

S. 2697 as introduced contained similar provisions regarding the regulation of single-stock futures, but would have permitted the trading of single-stock futures on stock exchanges, as well as on futures markets. S. 2697 also specified that any market where single-stock futures were traded would have to maintain a real-time audit trail of all transactions in those contracts.

Trading of single-stock futures raised questions of regulatory jurisdiction. Would they be traded on stock exchanges, futures exchanges, or both? Would traders be subject to securities regulation, futures regulation, or both? H.R. 4541 as reported by the Agriculture Committee viewed single-stock futures as futures contracts to be traded on futures exchanges under CFTC oversight. The House Commerce version of H.R. 4541, on the other hand, treated single-stock futures as securities, and gave the SEC the primary regulatory role. In September 2000, the SEC and CFTC reached an agreement on how these instruments should be traded and regulated. The two agencies coined the term "security futures" for single-stock or narrow-index futures contracts. The agreement called for them to be traded on both stock and futures exchanges, with all traders subject to the core principles of both futures and stock regulation. Clearing houses that cleared security futures would have to be linked, and margin requirements for security futures would have to be at least as high as margins for comparable stock options. Transaction fees that apply to sales of stock and stock options would not apply to security futures.

The final CFMA incorporated the CFTC/SEC agreement, except that securities transaction fees will apply. The tax treatment of single-stock futures resembles the treatment of stock options (which are taxed under normal capital gains rules) rather than that of standard futures contracts, which receive special treatment. The law permitted trading of security futures to begin one year following enactment, but the process of writing regulations was time-consuming, and trading had not begun by year-end 2002.

Legislative History

H.R. 4541 was marked up by three House committees in the 106th Congress. H.Rept. 106-711 contains the three versions: Part 1 is the Agriculture Committee mark-up, Part 2 is Banking, and Part 3 is Commerce.

On June 27, 2000, the House Agriculture Committee reported H.R. 4541. The principal amendments were: (1) to permit U.S. futures brokers to sell certain foreign stock index futures contracts traded on foreign exchanges to U.S. citizens; and (2) to require OTC derivatives clearing houses to register with some regulatory agency. (Registration was voluntary in the bill as introduced.) H.R. 4541 was then sent to the committees on Commerce and Banking.

On July 20, 2000, the House Commerce Committee marked up H.R. 4541. The Commerce version gave the SEC considerably more authority over single-stock futures than did the bill as introduced, including the power to set margin requirements. Differences between the Commerce version and the Agriculture Committee's included (1) the Commerce bill allowed single-stock futures to be traded on stock exchanges, as well as on CFTC-regulated futures exchanges; (2) Commerce would have allowed the SEC to enforce the insider trading rules that apply to stocks on futures exchanges where single-stock futures were traded; and (3) the Commerce version required the National Futures Association to establish suitability standards for traders of single-stock futures.

On July 27, 2000, the House Banking Committee marked up H.R. 4541. Its version would have (1) permitted the development of a retail swaps market, outside of CFTC regulation, provided that the contracts were offered by a bank to customers with over $5 million in assets and that the banking regulators had issued customer protection rules; (2) created antifraud provisions for retail derivatives; (3) gave the Fed supervisory authority over OTC derivatives clearinghouses; and (4) excluded from CFTC authority banking and securities products offered by banks, brokers, or insurance companies.

On June 29, 2000, the Senate Agriculture Committee finished its markup of S. 2697. Changes to the bill included (1) the SEC and CFTC would have to notify each other if either approved single-stock futures for trading by markets under its jurisdiction (the bill as introduced required agency approval, not just notification); (2) a requirement for harmonization of trading costs between single-stock futures and stock options; (3) U.S. futures brokers would be allowed to sell foreign stock index futures, provided that the index was not based on U.S. stocks; and (4) the National Futures Association would be required to develop an industry-wide suitability disclosure standard.

A version of H.R. 4541 that incorporated elements of all three House markups was passed by the House under suspension of the rules on October 19, 2000. S. 2697 never came to a vote on the Senate floor.

On December 14, 2000, identical bills H.R. 5660 and S. 3282 were introduced, after negotiations among House and Senate committees, regulators, and executive branch agencies. On December 20, H.R. 5660 was incorporated by reference into H.R. 4577, the Consolidated Appropriations Act, which was passed by both houses of Congress. On December 21, 2000, this omnibus measure, which now included the Commodity Futures Modernization Act of 2000, became P.L. 106-554.

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