With respect to access to foreign security futures by U.S. persons, are the conditions contained in the SEC Order consistent with Section 2(a)(1)(F)(i) of the CFTC? Should ECPs that are not QIBs be permitted to trade foreign security futures? What conditions, if any, should be imposed on such trading by ECPs that are QIBs, and ECPs that are not QIBs? How should an order permitting ECPs to trade foreign security futures take into account, as mandated by Section 2(a)(1)(E) of the CEA, “the nature and size of the markets that the securities underlying the security futures product reflects?”

(9) Nature of Foreign Security Indexes: Lying at the core of the complex interplay between HEF’s Petition on the one hand, and the CEA and the federal securities laws on the other hand, is the application of the statutory definition of a “narrow-based security index” to foreign security indexes. To the extent that a foreign security index falls squarely on the broad-based side of the line, distinctions between ECPs that are QIBs and those that are not, and the prospect of an ECP that is relying on the relief requested by HEF violating the securities laws, may be of less concern.

Congress has recognized that “[t]he detailed statutory test of a narrow-based security index was tailored to fit the U.S. equity markets, which are by far the largest, deepest and most liquid securities markets in the world. A difference in legal status, should an order issued by the Commission granting the relief requested in HEF’s Petition be limited to QIBs?

As discussed above, the SEC Order generally limits the category of U.S. persons that may trade foreign security futures to QIBs (who own and invest $100 million or more). This is a narrower class of investors than ECPs. The group of persons that satisfy the ECP definition but may not be QIBs includes registered investment companies, commodity pools, pension plans, and high net worth individuals. These persons may have a real need for risk management based upon exposures in foreign financial markets or to economic conditions in other countries, or they may want to gain exposure to those markets as part of the asset allocation in their investment portfolio.

If the relief requested in HEF’s Petition is granted, an ECP that is a QIB and trades a foreign futures contract on a foreign security index that moves from broad to narrow-based can continue to trade that contract as a foreign security futures contract otherwise meets the requirements of the SEC Order. An ECP that is not a QIB, however, would have to exit its position in the foreign futures contract within the applicable grace period or be in violation of the Exchange Act. Given this difference in legal status, should an order issued by the Commission granting the relief requested in HEF’s Petition be limited to QIBs?

U.S. underlying narrow-based security indexes, paragraph (1)(a)(iii) of the SEC Order permits debt securities issued or guaranteed by a foreign government as defined in Rule 405 of the Securities Act, 17 CFR 230.405, that are eligible to be registered with the SEC under Schedule B of the Securities Act, 15 U.S.C. 77aa. Further, paragraph (1)(a)(iii) requires that at the time of the transaction, at least 90% of the index, both in terms of the number of underlying securities and their weight, at the time of the transaction, that do not meet the requirements, may be from issuers that are required to file reports with the SEC pursuant to Section 13 or Section 15(d) of the Exchange Act, 15 U.S.C. 78m and 78o.


33 Public Law No. 110–246, 122 Stat. 1651 (June 18, 2008).

Futures U.S., Inc. ("ICE Futures") at the time of acceptance for clearing. Authority for extending this relief is found in Section 4(c) of the Act.

DATES: Comments must be received on or before August 2, 2010.

ADDRESS: Comments may be submitted by any of the following methods:
- E-mail: iceclearotc4@cftc.gov. Include "ICE Clear Section 4(c) Amended Exemption Request" in the subject line of the message.
- Fax: 202–418–5521.
- Mail: Send to David A. Stawick, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.
- Courier: Same as mail above.

All comments received will be posted without charge to http://www.CFTC.gov/. Comments must be received on or before August 2, 2010.

SUPPLEMENTARY INFORMATION:

I. Background

In September 2007, ICE Clear, a registered derivatives clearing organization ("DCO") and the clearing organization for ICE Futures, submitted applications to the Commission requesting an order (1) pursuant to Section 4(c) of the Act, (a) to permit the clearing of coffee, sugar, and cocoa OTC swap contracts and (b) to determine that certain ICE Futures floor brokers and traders are eligible swap participants ("ESPs") for the purpose of clearing these OTC swaps; and (2) pursuant to Section 4d of the Act, to permit certain customer positions in these cleared OTC swap contracts and the property collateralizing these positions to be commingled with property and positions otherwise required to be held in customer segregated accounts. Part 35 of the Commission’s regulations allows the trading but not the clearing of such contracts. On December 12, 2008, the Commission approved the applications and issued an order pursuant to Sections 4(c) and 4d of the Act (the "Previous Order"). ICE Clear represents that it commenced clearing the permitted swaps on February 13, 2009.

The clearing process for these swaps involves the replacement of each OTC swap with a "cleared-only" contract, the essential terms of which match the terms, including the expiration date, of a corresponding underlying exchange-listed futures contract in coffee, sugar, or cocoa traded on ICE Futures. The clearinghouse is interposed as the central counterparty. The cleared-only contracts are financially settled while the underlying futures contracts are settled with physical delivery.

In granting the relief requested, the Commission imposed certain terms and conditions in the Previous Order to address its regulatory concerns and mitigate the risks associated with the clearing of OTC agricultural swaps. With respect to Section 4d of the Act, the Commission determined whether ICE Clear’s proposal would provide appropriate protection for customer funds since futures customers would be exposed to a different source of risk if funds supporting contracts executed in the OTC market were commingled with customer funds supporting futures transactions in customer segregated accounts. In analyzing this issue, the Commission considered (1) the ability of a futures commission merchant ("FCM") or DCO to offset these contracts in the OTC markets in the event of a default on such a customer's OTC contract or an FCM, respectively, since a cleared-only contract could be offset only by another cleared-only contract and (2) the availability of the exchange-traded markets for coffee, sugar, and cocoa for hedging purposes, as well as the correspondence between the terms of a cleared-only contract and a corresponding exchange-traded contract for these products. Based on ICE Clear’s proposal, the Commission found that these cleared-only contracts correspond to transactions in a potentially liquid OTC market and, importantly, that they were economically equivalent to, and thus could be effectively hedged with an exchange-listed futures contract.

Accordingly, in order to ensure an effective means of risk management for these cleared-only contracts, the Commission included Condition 3(B) in the Previous Order, which required that the cleared-only contracts be closely related to underlying futures contracts traded on ICE Futures. Specifically, Condition 3(B) provides that:

"[t]he economic terms and the daily settlement prices of each contract, agreement or transaction subject to this order must be analogous to the economic terms, and equal to the daily settlement prices, respectively, of a corresponding futures contract listed for trading on ICE Futures."

The fulfillment of this condition would enable an FCM carrying the positions of a defaulting customer or ICE Clear carrying the positions of a defaulting member, to economically hedge those positions in the ICE Futures market by entering into an equal but opposite position in the corresponding listed futures contract. Thus, the commission is considering allowing ICE Clear to add the positions of a customer economic hedging in the exchange-listed market and actual offset based on the OTC market as feasible risk management measures for FCMs carrying cleared-only positions, as well as for ICE Clear itself.

II. The Current ICE Clear Petition

ICE Clear seeks to modify Condition 3(B) of the Previous Order to allow it to clear OTC swaps in coffee, sugar and cocoa that have economic terms analogous to the terms of corresponding futures contracts listed for trading on ICE Futures with the exception of their expiration dates. Such expiration dates would be permitted to be beyond that of the corresponding futures contracts. These OTC swap contracts are referred to herein as "Long-Dated Swaps". The clearing of Long-Dated Swaps will require ICE Clear to establish independent settlement prices for such swaps until there is a corresponding futures contract, with the same expiration date, listed for trading on ICE Futures.

See 73 FR at 77018.

2 17 CFR Part 35.
3 Part 35 of the Commission’s regulations, 17 CFRPart 35, promulgated pursuant to the authority of Section 4(c) of the Act, exempts swap agreements and eligible persons entering into these agreements from most provisions of the Act. The term "swap agreement" is defined to include, among other types of agreements, "a * * * commodity swap," which latter term includes swaps on agricultural products. While the Commodity Futures Modernization Act of 2000 amends the Act to exempt the trading of many OTC transactions from many provisions of the Act, these exemptions explicitly do not apply to OTC transactions in agricultural commodities. Accordingly, swaps involving agricultural commodities continue to rely upon the exemptions of Part 35. Part 35 requires, among other things, that a swap agreement be a part of a fungible class of agreements that are standardized as to their material economic terms and that the creditworthiness of any party having an interest under the agreement be a material consideration in entering into or negotiating the terms of the agreement. Thus, absent an additional exemption pursuant to Section 4(c) of the Act, ICE Clear seeks in the clearing of OTC swap contracts in cocoa, sugar and coffee, since such contracts would not fulfill all of the conditions for exemption for Part 35. For further discussion of the Part 35 analysis, see 72 FR 68862, 68863 (Dec. 6, 2007).
4 As discussed further below, the Commission is requesting comment on the impact of pending financial services reform legislation on Part 35.
5 See 73 FR 77015 (Dec. 18, 2008).
Futures. In order to establish such prices, ICE Clear represents that it has developed specific pricing models for Long-Dated Swaps and will use those models along with the best available market data to determine settlement prices. In addition, ICE Clear represents that only ESPs would be permitted to trade these swaps.

ICE Clear has not requested an order pursuant to Section 4d of the Act permitting customer positions in these Long-Dated Swap contracts and the property collateralizing those positions to be commingled with property and positions otherwise required to be held in customer segregated accounts. Accordingly, positions in such contracts, and property collateralizing such positions, would not be commingled with positions and related collateral segregated pursuant to Section 4d of the Act. Long-Dated Swaps, and property collateralizing such swaps, would be treated as other cleared-only contracts by ICE Clear and its clearing members that are registered as FCMs.

Eventually, however, the expiration date of a Long-Dated Swap will, after the passage of time, correspond to that of a futures contract listed for trading by ICE Futures (at that point, the Long-Dated Swap would become an “Aged Long-Dated Swap”). An Aged Long-Dated Swap would be economically equivalent to an OTC swap that was first accepted for clearing after the listing of a corresponding futures contract. As a result, an Aged Long-Dated Swap would also satisfy all the requirements specified in the Previous Order, and therefore, could be carried in the customer segregated account pursuant to the provisions of that order. ICE Clear would not establish an independent settlement price for an Aged Long-Dated Swap, but instead would use the settlement price of the corresponding listed futures contract.

III. Section 4(c) of the Commodity Exchange Act

Section 4(c)(1) of the Act empowers the Commission to “promote responsible economic or financial innovation and fair competition” by exempting any transaction or class of transactions from any of the provisions of the Act (subject to exceptions not relevant here) where the Commission determines that the exemption would be consistent with the public interest. The Commission may grant such an exemption by rule, regulation, or order, after notice and opportunity for hearing, and may do so on application of any person or on its own initiative. In enacting Section 4(c) of the Act, Congress noted that the goal of the provision “is to give the Commission means of providing certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner.”

Pursuant to recent amendments to Part 190 of the Commission’s Regulations, 17 CFR Part 190, positions in these contracts, and related collateral, could be included as Cleared OTC Derivatives, if ICE Clear’s rules or bylaws were to require them to be segregated. The amendments were published at 75 FR 17297 (Apr. 6, 2010).

Section 4(c)(2) provides that the Commission may grant exemptions only when it determines that the requirements for which an exemption is being provided should not be applied to the agreements, contracts, or transactions at issue, and the exemption is consistent with the public interest and the purposes of the Act; that the agreements, contracts or transactions will be entered into solely between appropriate persons; and that the exemption will not have a material adverse effect on the ability of the Commission or any contract market or derivatives transaction execution facility to discharge its regulatory or self-regulatory duties under the Act. Section 4(c)(3) includes within the term “appropriate persons” a number of specified categories of persons deemed appropriate under the Act for entering into transactions exempt by the Commission under Section 4(c). This includes persons the Commission determines to be appropriate in light of their financial or other qualifications, or the applicability of appropriate regulatory protections. ESPs, as defined in Part 35 of the Commission’s regulations, and ICE Futures floor members deemed ESPs by the Commission in the Order, will be eligible to submit Long-Dated Swap transactions to ICE Clear for clearing. The proposed Order requires ICE Clear, FCMs and ESPs accepted for clearing in the Order to provide the market and large-trader information described in Parts 16, 17 and 18 of the Commission’s regulations, in the manner described in

Footnotes:

6 ICE Clear proposes to use a process similar to the industry-proposed pricing procedures for options pricing models used to value longer dated options positions in less liquid contract months. Moreover, ICE Clear represents that the market data used will include: (i) Cleared-swaps data submitted to the clearinghouse; (ii) year-on-year spread values for the underlying traded futures contract for actively traded months; (iii) OTC transaction data solicited from third-party brokers such as the major inter-dealer brokers; (iv) indicative prices quoted by third-party brokers; and (v) historical data.

7 Pursuant to recent amendments to Part 190 of the Commission’s Regulations, 17 CFR Part 190, positions in these contracts, and related collateral, could be included as Cleared OTC Derivatives, if ICE Clear’s rules or bylaws were to require them to be segregated. The amendments were published at 75 FR 17297 (Apr. 6, 2010).

8 Section 4(c)(1) of the Act, 7 U.S.C. 6(c)(1), provides in full that: 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 or registered as a contract market or derivatives transaction execution facility for transactions for future delivery in any commodity listed for trading on a contract market or designated contract market) exempt any agreement, contract, or transaction (or class thereof) that is otherwise subject to subsection (a) of this section (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) of this section, or from any other requirement of this chapter (except subparagraphs (e), (f), (g), (h), and (i) of each of sections 4, 5, and 6 of this chapter), except that the Commission and the Securities and Exchange Commission may by rule, regulation, or order joinly exclude any agreement, contract, or transaction from section 2(a)(10)(B) of this title, if the Commission determines that the exemption would be consistent with the public interest.


10 Section 4(c)(2) of the Act, 7 U.S.C. 6(c)(2), provides in full that: The Commission shall not grant any exemption under paragraph (1) from any of the requirements of subsection (a) of this section 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 or derivatives transaction execution facility to discharge its regulatory or self-regulatory duties under this Act.

11 This definition includes many of the classes of persons explicitly referred to in Act Section 4(c)(3) (e.g., a bank or trust company) as well as some classes of persons who are included under the category of Section 4(c)(3)(K) (“such other persons that the Commission determines to be appropriate in light of their financial or other qualifications, or the applicability of appropriate regulatory protections”).
Parts 15, 16, 17 and 18 of the Commission’s regulations, with respect to all Cleared-Only Contracts, including Long-Dated Swaps. In light of the above, the Commission is requesting comment as to whether the extension of this exemption will affect the ability of the Commission or any contract market or derivatives clearing organization to discharge its regulatory or self-regulatory duties under the Act.

With respect to protecting the public interest, the Commission notes that Congress has begun to take steps to promote transparency in swap contracts. The financial services reform bills passed by the House of Representatives and by the Senate each require swaps to be cleared, subject to certain exemptions, and further requires, with respect to swaps that are subject to the clearing requirement, that such swaps be executed on a board of trade designated as a contract market under Section 5 of the Act (“DCM”) or on a swap execution facility (“SEF”) registered or exempt under Section 5h of the Act (where such a trading environment is available). Although these bills have not completed the legislative process, the Commission recognizes that future legislative enactments may require the execution of cleared swaps on a DCM or SEF. Accordingly, the Commission seeks comment, both as to the current proposed exemption, as well as more generally with respect to Part 35 of the Commission’s regulations, on the issues raised by the pending legislation regarding trading requirements for swap contracts, including agricultural swap contracts.

IV. Amended Order

The Previous Order is proposed to be revised to read as follows:

ORDER

(1) The Commission, pursuant to its authority under Section 4(c) of the Commodity Exchange Act (“Act”) and subject to the conditions below, hereby:

(a) Permits eligible swap participants (“ESPs”) to submit for clearing, and futures commission merchants (“FCMs”) and ICE Clear to clear, OTC agricultural swap contracts in coffee, sugar, and cocoa (“Cleared-Only Contracts”); and
(b) Permits all ICE Futures floor members that are registered with the Commission, when trading for their own accounts, to be deemed ESPs for the purpose of entering into bilateral swap transactions involving coffee, sugar, or cocoa to be cleared on ICE Clear.

(2) The term “Long-Dated Swap Contract” shall be defined as a Cleared-Only Contract with terms analogous to those of a corresponding futures contract listed for trading on ICE Futures, except that the expiration date of the swap contract is later than that of any such futures contract. If the expiration date of a Long-Dated Swap Contract, after the passage of time, is on or before that of a futures contract listed for trading on ICE Futures, such OTC swap contract will become an “Aged Long-Dated Swap Contract”.

(3) The Commission, pursuant to its authority under Section 4d of the Act and subject to the conditions below, hereby permits ICE Clear clearing members that are registered FCMs, acting pursuant to this order, to hold money, securities, and other property, used to margin, guarantee, or secure Cleared-Only Contracts (with the exception of Long-Dated Swap Contracts) and certain other swaps (including customers that are deemed ESPs in accordance with this order), with other customer funds used to margin, guarantee, or secure trades or positions in commodity futures or commodity option contracts executed on or subject to the rules of a contract market designated pursuant to Section 5 of the Act in a customer segregated account or accounts maintained in accordance with Section 4d of the Act (including any orders issued pursuant to Section 4d(2) of the Act) and the Commission’s regulations thereunder, and all such customer funds shall be accounted for and treated with as belonging to the customers of the ICE Clear clearing member, consistent with Section 4d of the Act and the regulations thereunder. This permission shall also apply to a Long-Dated Swap Contract.

(4) The Order is subject to the following conditions:

(a) The contracts, agreements, or transactions subject to this order shall be executed pursuant to the requirements of Part 35 of the Commission’s regulations, as modified herein, and shall be limited to Cleared-Only Contracts as defined herein.
(b) The economic terms and the daily settlement prices of each contract, agreement, or transaction subject to this order, except for a Long-Dated Swap Contract, shall be analogous to the economic terms, and equal to the daily settlement prices, respectively, of a corresponding futures contract listed for trading on ICE Futures.
(c) ICE Clear shall establish a settlement price for each Cleared-Only Swap Contract for each trading day until such time as the contract’s expiration date corresponds to that of a futures contract listed for trading on ICE Futures. ICE Clear shall make records reflecting the basis for setting each such price and shall maintain such records pursuant to Core Principle K.
(d) All contracts subject to this order shall be submitted for clearing by an ICE Futures clearing member to ICE Clear pursuant to ICE Clear rules.
(e) Each ICE Futures floor member, acting as an ESP pursuant to this order, shall be the subject of a financial guarantee from a ICE Clear clearing member of ICE Clear covering the trading of the OTC swap contracts subject to this order. The clearing member shall be registered with the Commission as a FCM and shall clear for the floor member the contracts, agreement, or transactions covered by the financial guarantee.
(f) An ICE Futures floor member shall be prohibited from entering into a transaction in a Cleared-Only Contract with another ICE Futures floor member as the counterparty.
(g) ICE Clear and its clearing members shall mark to market each Cleared-Only Contract on a daily basis in accordance with ICE Clear rules.
(h) ICE Clear shall apply its margining system and calculate performance bond rates for each Cleared-Only Contract in accordance with its normal and customary practices.
(i) ICE Futures shall maintain appropriate compliance systems to monitor the transactions of its floor members in the OTC swap transactions permitted pursuant to this order.
(j) ICE Clear shall apply appropriate risk management procedures with respect to transactions and open interest in all Cleared-Only Contracts. ICE Clear shall conduct financial surveillance and oversight of its members clearing Cleared-Only Contracts, and shall conduct oversight sufficient to assure ICE Clear that each such member has the appropriate operational capabilities necessary to manage defaults in such contracts. ICE Clear and its clearing members, acting pursuant to this order, shall take all other steps necessary and appropriate to manage risk related to clearing Cleared-Only Contracts.
(k) ICE Clear shall make available open interest and settlement price information for the Cleared-Only Contracts on a daily basis in the same manner as for futures contracts listed for trading on ICE Futures.
(l) ICE Futures shall establish and maintain a coordinated market surveillance program that encompasses the Cleared-Only Contracts and the corresponding futures contracts listed by ICE Futures on its designated contract market. ICE Futures shall adopt position accountability levels for each cleared-only contract that are appropriate in light of the position accountability levels applicable to the corresponding futures contracts listed for trading on ICE Futures.
(m) Cleared-only contracts shall not be treated as fungible with any contract listed for trading on ICE Futures.
(n) Each FCM acting pursuant to this order shall keep the types of information and records that are described in Section 4g of the Act and Commission regulations thereunder, including but not limited to ICE Futures Cooperative Regulation 1.35, with respect to all Cleared-Only Contracts. Such information and records shall be produced for inspection in accordance with the requirements of Commission Regulation 1.31.
(o) ICE Futures shall provide to the Commission the types of information
would be subject to the exemption. Information from any entities that approved, require a new collection of conducting or sponsoring any collection Commission) in connection with their Sections 4(c) and 4d of the Act and all reporting requirements to all Cleared-Only Contracts in which it participates. (q) ICE Clear and ICE Futures shall at all times fulfill all representations made in their requests for Commission action under Sections 4(c) and 4d of the Act and all supporting materials thereto.

V. Request for Comment

The Commission requests comment on all aspects of the issues presented by this amended exemption request. VI. Related Matters

A. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 ("PRA")16 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. The amended exemption would not, if approved, require a new collection of information from any entities that would be subject to the exemption.

B. Cost-Benefit Analysis

Section 15(a) of the Act,17 requires the Commission to consider the costs and benefits of its action before issuing an order under the Act. By its terms, Section 15(a) does not require the Commission to quantify the costs and benefits of an order or to determine whether the benefits of the order outweigh its costs. Rather, Section 15(a) simply requires the Commission to “consider the costs and benefits” of its action.

Section 15(a) of the Act further specifies that costs and benefits shall be evaluated in light of five broad areas of market and public concern: protection of market participants and the public; efficiency, competitiveness, and financial integrity of futures markets; price discovery; sound risk management practices; and other public interest considerations. Accordingly, the Commission could in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular order was necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the Act.

The Commission is considering the costs and benefits of an amended exemption order in light of the specific provisions of Section 15(a) of the Act, as follows:

1. Protection of market participants and the public. The contracts that are the subject of the amended exemption request will only be entered into by persons who are “appropriate persons” as set forth in Section 4(c) of the Act.

2. Efficiency, competition, and financial integrity. Extending the exemption granted under Part 35 to allow the clearing of Long-Dated Swap Contracts may promote liquidity and transparency in the markets for OTC derivatives in coffee, sugar, and cocoa, as well as for futures on those commodities. Extending the exemption also may promote financial integrity by increasing the benefits of clearing in these OTC markets.

3. Price discovery. Price discovery may be enhanced through market competition.

4. Sound risk management practices. Clearing of Long-Dated Swap Contracts may foster risk management by the participant counterparties. ICE Clear’s risk management practices in clearing these transactions would be subject to the Commission’s supervision and oversight.

5. Other public interest considerations. The requested amended exemption may encourage market competition in agricultural derivative products without unnecessary regulatory burden. As noted above, however, there are pending financial services reform bills that would affect the trading and clearing requirements for agricultural swap contracts.

After considering these factors, the Commission has determined to seek comment on the request for an amended exemption order as discussed above. The Commission also invites public comment on its application of the cost-benefit provision.

* * * * *

Issued in Washington, DC, on June 14, 2010 by the Commission.

Sautia S. Warfield.

Assistant Secretary of the Commission.