THE COMMODITY FUTURES MODERNIZATION ACT OF 2000

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Signed into law by President Clinton on December 21, 2000, the Commodity Futures Modernization Act of 2000 (the "CFMA") transforms the regulatory framework covering exchange-traded futures, over-the-counter derivatives, and futures options. The CFMA embodies more than three years of congressional negotiation, during which time uncertainty over the status of certain derivatives and futures products threatened the loss of business to overseas markets.

The CFMA effects changes in the Commodity Exchange Act (the "CEA"), the Securities Act of 1933 (the "Securities Act"), the Securities Exchange Act of 1934 (the "Exchange Act"), and other federal legislation. This memorandum addresses some of the key changes in the securities laws resulting from the CFMA and related tax provisions enacted under the Community Renewal Tax Relief Act of 2000.

1. Treasury Amendment

- Prior to the CFMA, the so-called "Treasury Amendment," Section 2(a)(1)(A)(ii) of the CEA, excluded from the CEA foreign currency transactions, as well as security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, and mortgages or mortgage purchase commitments. However, uncertainty over the types of instruments and contract participants covered frustrated the seemingly broad exclusion afforded by the Treasury Amendment.

- The CFMA now provides a clear exclusion for all foreign currency transactions, government securities, security warrants, security rights, resales of installment loan contracts, repurchase transactions in an excluded commodity, and mortgages or mortgage purchase commitments entered into between "eligible contract participants" (ECPs).

    - The CFMA defines ECPs to include financial institutions, insurance companies, investment companies, certain commodity pools, large corporations and partnerships, certain employee benefit plans subject to ERISA, governmental entities, broker-dealers subject to Exchange Act regulation, futures commission merchants subject to CEA regulation, floor brokers or traders subject to CEA regulation in connection with transactions conducted on the facilities of registered entities or boards of trade, and individuals who: (1) have assets in excess of $10 million or (2) assets in excess of $5 million who enter into the transaction for risk management purposes.

- Under the new rules, the Commodity Futures Trading Commission (the "CFTC") retains jurisdiction over those transactions that do not satisfy the foregoing exclusions or that are conducted on an organized exchange. However, if the non-ECP counterparty is a regulated financial entity (e.g., a broker/dealer or an investment company), the broader exclusion outlined above will apply and the CFTC will not have jurisdiction.

2. Over-the-Counter Derivatives, Swaps, and Other Excluded or Exempted Products

- Prior to enactment of the CFMA, certain over-the-counter derivatives could be seen to violate the CEA's prohibition on off-exchange futures contracts or commodity options. While the CFTC exempted certain financial products and issued corresponding interpretive guidelines, the CFTC could not exempt security-based products. Moreover, uncertainty relating to over-the-counter products has especially plagued retail, as opposed to institutional, transactions, resulting in significant litigation.

- The CFMA creates a broad exclusion from the CEA for any transaction between ECPs involving any "excluded commodity,"[1] provided that such transaction is not executed on a "trading facility." However, a transaction between ECPs that is consummated on an electronic trading facility is excluded if the transaction is negotiated on a principal-to-principal basis.

- The CFMA also provides legal certainty for all individually negotiated swap transactions entered into by ECPs by excluding any such swap from the definition of a "security" under the Securities Act and the Exchange Act. The anti-fraud and anti-manipulation provisions, as well as the insider trading proscriptions of these Acts will, however, apply to all "security-based swaps." As a result of the new rules, the CFMA will now permit trading of qualifying swaps without requiring broker-dealer registration.

- The CFMA excludes from the CEA any contract, agreement, or transaction not entered into on a trading facility and between ECPs in an "exempt commodity," defined under the new rules to mean any commodity that is

[1] The CFMA defines "excluded commodity" to include: an interest rate, exchange rate, currency, security, security index, credit risk, debt or equity instrument, index or measure of inflation, or a host of other measures not within the parties' control.

neither an excluded commodity or an agricultural commodity. Exempt commodities include most physical commodities, such as metals and energy.

- The CEA's anti-fraud and anti-manipulation rules continue to apply to transactions in exempt commodities entered into by ECPs.

- Transactions between "eligible commercial entities" (ECEs),[2] however, are not subject to the anti-fraud and anti-manipulation rules. Moreover, such transactions, if negotiated on a principal-to-principal basis between ECEs, may be made on an electronic trading facility.

3. Hybrid Instruments and Banking Products.

- The CFMA substantially diminishes the uncertainty surrounding so-called "hybrid instruments," defined under the CFMA as "securit[ies] having one or more payments indexed to the value, level, or rate of, or providing for the delivery of, one or more commodities."

- The new law creates a broad exclusion from the CEA for hybrid instruments, provided they are "predominantly" securities. The CFMA establishes a four-part test by which to determine security predominance. A hybrid instrument will be considered predominantly a security if: (a) the issuer receives payment in full of the purchase price contemporaneously with delivery of the instrument; (b) the purchaser is not required to make any payment to the issuer over the purchase price (e.g., margin or settlement payments); (c) the issuer of the hybrid is not subject to mark-to-market margining requirements; and (d) the hybrid is not marketed as a futures contract or option thereon.

- The new predominance test applied to hybrid instruments eliminates the need for hybrids to meet mechanical quantitative requirements formerly imposed by the CFTC under its statutory interpretation and hybrid instrument rules. The new law substantially clarifies the status of hybrid instruments, as well as simplifies the applicable exclusions.

- Title IV of the CFMA, the Legal Certainty for Bank Products Act of 2000, creates a similar exclusion for bank products and hybrid instruments. Under the new law, the CEA excludes any identified banking product, as defined

[2] The CFMA defines "eligible commercial entities" to include most ECPs. To be an eligible commercial entity, however, the ECP must, in connection with its business, make or take delivery of the underlying commodity, provide risk management services, or regularly enter into commodity derivative transactions.

under the Gramm-Leach-Bliley Act[3], provided that: (a) an appropriate banking agency certifies that the product has been commonly offered in the United States by any bank on or before December 5, 2000; and (b) the product was not prohibited by the CEA and not regulated by the CFTC as a futures contract or option thereon. An identified banking product offered by a bank after December 5, 2000, is excluded from the CEA provided that: (a) the product does not include a payment indexed to the value of, and does not provide for delivery of, a commodity; and (b) the product is otherwise excluded from the CEA.

- Using a similar predominance test to the one described above, the CFMA broadly excludes hybrid instruments that are predominantly banking products.

4. Securities Futures

- The CFMA repeals the so-called Shad/Johnson Accord, codified under Section 2 (a)(1)(B) of the CEA, which prohibited trading in the United States of futures on individual, non-exempt securities or narrow indices of such securities. Moreover, under the former law, the CFTC could not, under its exemptive authority, grant exemptions from the Accord. The Shad/Johnson Accord resulted in greater restrictions for securities-based derivatives than the restrictions applicable to derivatives based on physical commodities.

- With the repeal of the Shad/Johnson Accord, the new law permits trading and listing of futures on individual, non-exempt securities and narrow indices of such securities, subjecting these products to regulation by both the SEC and the CFTC. While the new law subjects stock futures to margin requirements essentially equivalent to those imposed on listed stock options, the CFMA exempts such futures from the so-called up-tick limitation applicable to short sales.

- The CFMA requires that stock futures be traded on trading facilities registered with both the SEC and the CFTC. Such trading facilities may include: national securities exchanges, national securities associations, alternative trading systems, contract markets, futures exchanges and Derivative Transaction Execution Facilities (see below). The CFMA provides an expedited registration procedure for securities exchanges and futures exchanges needing to register as futures exchanges or securities exchanges,

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3 Section 206(a) of the Gramm-Leach-Bliley Act defines "identified banking product" to cover a wide array of common bank products, including certificates of deposit, letters of credit, loan participations, and swap agreements.

respectively, for the purpose of trading stock futures. Furthermore, the intermediaries in stock futures transactions must register as both broker-dealers and registered futures commission merchants. The CFMA also provides an expedited cross-registration process for broker-dealers and futures commission merchants.

- The CFMA phases in the provisions relating to stock futures. Stock futures may not be offered on a U.S. trading facility until at least a year after the CFMA's effective date. A shorter transition applies to transactions between ECPs negotiated on a principal-to-principal basis. Such transactions may not be offered until at least eight months after the CFMA's effective date.

- New Section 1234B of the Internal Revenue code of 1986, as amended, (the "Code"), provides that a securities futures contract will be taxed like an equity option, as long as it is not a dealer securities futures contract[4]. Therefore, gain or loss upon the sale or exchange of a securities futures contract will be considered gain or loss from the sale or exchange of the underlying property. In addition, if the underlying property is a capital asset, such gain or loss will generally be treated as short-term capital gain or loss.

- Dealer securities futures contracts will be taxed in the same manner as regulated futures contracts under Section 1256 of the Code, which provides that dealer securities futures contracts will be marked-to-market and 40% of such gain or loss will be treated as short-term capital gain or loss and the remaining 60% will be treated as long-term capital gain or loss.

5. Pre-emption of State Law and Non-Repudiation of Contracts

- The CFMA broadens the pre-emption of state gaming and bucket shop laws by extending protection to any of the transactions or products excluded or exempted from the CEA. Moreover, the CFMA protects all agreements, transactions, or contracts between ECPs and all hybrid instruments, irrespective of ECP status, by proscribing rescission when the sole reason for it is that the instrument or transaction in question failed to comply with an available exclusion or exemption under the CEA or any of the CFTC's regulations.

[4] A dealer securities futures contract means, with respect to any dealer, any securities futures contract or option on such a contract that is entered into, or granted or purchased by, a dealer in the normal course of activity of dealing in such contracts or options and is traded on a qualified board or exchange.

- By amending section 28(a) of the Exchange Act, the CFMA pre-empts state gaming and bucket shop laws with regard to any security subject to the provisions of the Exchange Act, irrespective of whether it is listed on a securities exchange.

6. Exchanges and Derivatives Transactions Execution Facilities

- The CFMA creates a three-tiered regulatory approach to contract markets and futures exchanges. Each type of exchange facility under the CFMA has a different applicable level of regulation and corresponding restrictions with regard to the entities that may use the facility and the types of instruments that may trade on it.

- The CFMA retains the category of designated contract markets; the new law, however, replaces the former designation procedures with broadly drawn "core principles" that the contract markets must comply with in order to remain designated contract markets. Such principles include: listing only those contracts that are not readily subject to manipulation; monitoring trading; and making information on trading readily available to participants. The CFMA subjects these markets to the highest level of regulation and allows a correspondingly high degree of flexibility with regard to the types of participants and the products that may be traded on such markets.

- An innovation of the CFMA, Registered Derivatives Transaction Execution Facilities (DTEFs) are subject to less regulation than designated contract markets and have varying degrees of restrictions with regard to the participants that may use DTEFs and the types of products that may be traded on DTEFs. The CFMA limits participation to ECPs (including individuals trading through qualified registered futures commission merchants) and ECEs. The new law limits trading to contracts highly unlikely to be susceptible to manipulation (e.g., the underlying commodity has no cash market).

- Exempt boards of trade, the second new trading facility created by the CFMA, have the lightest level of regulation but the greatest restrictions on the types of participants granted access to, and the instruments that may be traded on, such boards of trade. All transactions must be between ECPs and based on commodities that are highly unlikely to be susceptible of manipulation. Exempt boards of trade must comply with the anti-fraud and anti-manipulation provisions of the CEA, but otherwise are generally exempt from the other provisions of that act.

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