CME Group

A CME/Chicago Board of Trade/NYMEX Company

INTRODUCTION

This memorandum analyzes the treatment of certain customers of futures commission merchants under Subchapter IV of Chapter 7 of the U.S. Bankruptcy Code 11 U.S.C.A. §761 in respect of their over-the-counter ("OTC"), credit default swap contracts ("CDS") that are cleared through a futures commission merchant ("FCM") by the Chicago Mercantile Exchange Clearing House. The first question[1] we explore is whether the "customer" of the insolvent FCM with respect to OTC, CDS contracts that are cleared by CME, either in an account authorized by

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

"Commodity contract" is defined in Section 761 of the Bankruptcy Code to essentially mean a commodity futures contract or a commodity option.

In determining whether a cleared CDS is a commodity futures contract or a commodity option, a threshold question is whether a CDS is a futures contract or an option.

If it is a futures contract, then we believe, by definition, that it would be a commodity futures contract because the definition of "commodity" in Section 1a(4) of the CEA includes "goods and articles, except onions" and "all services, rights and interests in which contracts for future delivery are presently or in the future dealt in".

If it is an option contract, however, then the underlying deliverable must independently constitute a "commodity". To the extent the deliverable is a debt security, it would appear difficult to conclude that a CDS would be an option on a commodity, rather than on a security. If the deliverable is corporate indebtedness (such as a loan), or even if it is viewed as a credit event, then, in order for the CDS to constitute a commodity option, the corporate loan or credit event must be either (a) a good or article, or (b) a service, right or interest in which futures contracts are presently or in the future dealt in. What is the basis for concluding that a credit event or a corporate loan or credit event constitutes either (a) or, if a CDS is viewed as an option, (b) above?

If a claim in respect of cleared CDS does not constitute a "commodity contract", what is the treatment of such claims in the event of a commodity broker liquidation subject to Chapter 7 and Part 190? Can cleared CDS customers of the commodity broker benefit from the priority afforded to the "net equity" claims of conventional futures customers?

Does Section 20 of the CEA authorize the CFTC to promulgate an interpretation that deems a cleared CDS contract to be a "commodity contract" or provide other binding relief?

Commodity Futures Trading Commission ("CFTC") pursuant to Regulation §30.7 or in a Commodity Exchange Act ("CEA") Section 4d customer segregated account, will be deemed a "customer" of a "commodity broker" as defined in Section 761 of the Bankruptcy Code. We conclude that the answer to that question is "yes" and the customer will be treated as if he held and had margined exchange traded futures contracts. This conclusion depends on our determination that the cleared CDS contracts, single name and index, are commodity contracts as defined in Section 761(4).

The second question we explore is whether the CEA authorizes the CFTC to promulgate an interpretation that deems Cleared CDS to be "commodity contracts." We conclude that the answer is "yes" because the CFTC has authority to interpret the CEA to determine whether a proposed contract is within its jurisdiction and has done so in connection with CDS contracts.

The third question we explore is the treatment of Cleared CDS under the Bankruptcy Code and Part 190 in the event of a commodity broker liquidation if such contracts are not considered "commodity contracts." We conclude that even if Cleared CDS do not constitute "commodity contracts," the Cleared CDS that are held in a commodity futures account and all supporting customer property at the clearing house or FCM levels should be treated as a component of customer "net equity" within the meaning of the Bankruptcy Code and Part 190. This conclusion is based on CFTC Interpretation 73 FR 65514 (November 4, 2008.)

RESPONSE

I. Commodity Contracts

Section 761(4) of the Bankruptcy Code defines "commodity contract" as follows:

(A) with respect to a futures commission merchant, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade;
(B) with respect to a foreign futures commission merchant, foreign future;
(C) with respect to a leverage transaction merchant, leverage transaction;
(D) with respect to a clearing organization, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization, or commodity option traded on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization;
(E) with respect to a commodity options dealer, commodity option;
(F) any other agreement or transaction that is similar to an agreement or transaction referred to in this paragraph;

(G) any combination of the agreements or transactions referred to in this paragraph;
(H) any option to enter into an agreement or transaction referred to in this paragraph;
(I) a master agreement that provides for an agreement or transaction referred to in subparagraph (A), (B), (C), (D), (E), (F), (G), or (H), together with all supplements to such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a commodity contract under this paragraph, except that the master agreement shall be considered to be a commodity contract under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in subparagraph (A), (B), (C), (D), (E), (F), (G), or (H); or
(J) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this paragraph, including any guarantee or reimbursement obligation by or to a commodity broker or financial participant in connection with any agreement or transaction referred to in this paragraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562.

Accordingly, cleared credit default swaps ("Cleared CDS") are "commodity contracts" within the meaning of the Bankruptcy Code so long as they can be characterized as one of the following: (i) contracts for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade; (ii) commodity options; (iii) an agreement that is similar to any agreement referred to in Section 761(4); or (iv) any combination of the agreements referred to in Section 761(4).

II. Commodities

Section 1a(13) of the CEA, which defines the term "excluded commodity," specifically includes within the definition "credit risk or measure" as well as an occurrence, extent of an occurrence, or contingency:

The term "excluded commodity" means—
(i) an interest rate, exchange rate, currency, security, security index, *credit risk or measure*, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure;
(ii) any other rate, differential, index, or measure of economic or commercial risk, return, or value that is—
(I) not based in substantial part on the value of a narrow group of commodities not described in clause (i); or
(II) based solely on one or more commodities that have no cash market;

> **(iii)** any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction; or
> **(iv)** *an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in clause (i)) that is—*
> ***(I)*** *beyond the control of the parties to the relevant contract, agreement, or transaction; and*
> ***(II)*** *associated with a financial, commercial, or economic consequence*.

(emphasis added.) Notably, "an occurrence, extent of an occurrence, or contingency . . . that is beyond the control of the parties and associated with a financial, commercial, or economic consequence." does not require that such commodity interests correlate to market prices or that their economic consequences be broad-based. Rather, the occurrence or contingency must only be "associated with" a financial, commercial, or economic consequence.

Section 1a(4) of the CEA, which defines the term "commodity," is sweeping:

> The term "commodity" means wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all *other goods and articles*, *except onions as provided in Public Law 85-839 (7 U.S.C. 13-1), and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.*

(emphasis added.)

III. Securities

Section 2(a)(1) of the Securities Act of 1933 defines "security" as:

> Any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put call, straddle, *option or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on*

> *the value thereof)*, or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as "security, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

(emphasis added.) Thus, an option "on" any security or group or index of securities, including an option "based on the value thereof" constitutes a security.

IV. Credit Default Swaps

We recognize that there has been a debate as to the proper characterization of CDS for purposes of assessing whether the CFTC or the Securities Exchange Commission ("SEC") has jurisdiction to control exchange trading and clearing. Binary credit default swaps, that is CDS whose ultimate value are not based on the value of a security, have been deemed commodity futures contracts (indexes) and commodity options contracts (single name binary CDS). The SEC has taken the position that CDS that depend on the value of one or more securities or an index of securities, are options on "securities" that are excluded from the CFTC's jurisdiction. Specifically, the SEC contends that CDS that settle by delivery of the reference security or by reference to the price of the reference security are options on securities within the SEC's jurisdiction and not within the CFTC's exclusive jurisdiction, because they are "based on" a security or the value thereof. The SEC also characterized certain binary CDS contracts offered by CBOE as options on securities.

It is well established that contracts can be both commodity contracts and securities. The Seventh Circuit Court of Appeals recognized the hybrid nature of derivatives instruments in *Chicago Mercantile Exchange v. SEC*, 883 F.2d 537, 539 (7th Cir. 1989) (addressing the jurisdictional conflict created between the SEC and CFTC with respect to instruments that have characteristic of multiple instruments). Congress subsequently recognized this issue as well when enacting the Shad−Johnson Accord, which ultimately resolved the issue presented in the *Chicago Mercantile Exchange* case by clarifying the jurisdiction of the CFTC and SEC with respect to certain hybrid instruments. FUTURES TRADING ACT OF 1982, Pub. L. No. 97-444, 96 Stat. 2294 (1983); Act of Oct. 13, 1982, Pub. L. No. 97-303, 96 Stat. 1409. Specifically, the Shad−Johnson Accord precluded the CFTC from regulating options on securities, certificates of deposits and stock groups, but granted the CFTC jurisdiction over futures and options on futures on exempted securities and broad-based stock indices. *Id.* The issue was again recognized in 2000 in conjunction with the enactment of the Commodity Futures Modernization Act the ("CFMA"), which amended the Shad−Johnson Accord by granting the CFTC and SEC joint jurisdiction over futures on single stocks and narrow-based stock indices.

It is not relevant, for these purposes, that the SEC contends that it, rather than the CFTC has jurisdiction over CDS, including Cleared CDS,[2] that may be settled based on the value of a security. If those contracts are also commodity contracts, as defined in the CEA, and if they are held by customers of an FCM, the customer is entitled to the protections of SubChapter IV of Chapter 7 of the Bankruptcy Code, both respect to his contracts and to his property deposited with the FCM and the clearing house with respect to such contracts. Our analysis follows.

V. CDS Are Designed to Assume or Shift Credit Risk, Not Transfer the Value of Securities

A credit default swap is a credit derivative. A credit derivative may be defined as "a derivative designed to assume or shift credit risk, that is the risk" that a particular borrower will experience an event included within a specific set of credit events, such as loan defaults or bankruptcy filings, within a specified interval of time. *See* CFTC Glossary, *available at* (http://cftc.gov/educationcenter/glossary/glossary_co.html) "The obligation of a seller under a CDS to make payments under a CDS contract is triggered by a default or *other credit event* as to such entity or entities or such security or securities." (emphasis added.) SECURITIES AND EXCHANGE COMMISSION, (Release No. 34-57578; File No. S7-06-09) at 3, *available at* http://www.sec.gov/rules/exorders/2009/34-59578.pdf.

"CDS pricing is based on the probability that the reference entity will experience a credit event and the expected recovery rate." (CFTC Order dated June 5, 2007 at 3-4, ("Credit Index Event Order"), attached hereto as Exhibit A.) The CFTC has explained recovery rate as follows:

[2] "Cleared CDS" means a credit default swap that is submitted (or offered, purchased, or sold on terms providing for submission) to CME Clearing, that is offered only to, purchased only by, and sold only to eligible contract participants (as defined in Section 1a(12) of the Commodity Exchange Act as in effect on the date of this Order (other than a person that is an eligible contract participant under paragraph (C) of that section)), and in which: (1) the reference entity, the issuer of the reference security, or the reference security is one of the following: (i) an entity reporting under the Exchange Act, providing Securities Act Rule 144A(d)(4) information, or about which financial information is otherwise publicly available; (ii) a foreign private issuer whose securities are listed outside the United States and that has its principal trading market outside the United States; (iii) a foreign sovereign debt security; (iv) an asset-backed security, as defined in Regulation AB, issued in a registered transaction with publicly available distribution reports; or (v) an asset-backed security issued or guaranteed by the Fannie Mae, the Freddie Mac, or the Government National Mortgage Association ("Ginnie Mae"); or (2) the reference index is an index in which 80 percent or more of the index's weighting is comprised of the entities or securities described in subparagraph (1). SECURITIES AND EXCHANGE COMMISSION, (Release No. 34-57578; File No. S7-06-09) at 3, *available at* http://www.sec.gov/rules/exorders/2009/34-59578.pdf.

> The recovery rate is the amount the protection seller expects to recover if a credit event occurs. Changes in the expected probability of a credit event and/or the recovery rate will have an impact on CDS valuation. The larger the anticipated probability of default, the larger the credit default swap premium will be. If the market perceives that a reference entity's financial condition is improving, the CDS swap premium will tighten, *i.e.*, the CDS swap price will cheapen. If the price for CDS protection on a specific name is widening significantly, this is generally an indication that perceived credit quality is rapidly deteriorating. The CDS market often responds more quickly than the cash market to changes in credit perception. Hence, prices in the CDS market may serve as an important leading indicator that credit spreads on a particular bond issue are likely to change.

(*Id.* at 4 n. 9.) "The expected recovery rate is the fractional amount of par value that the protection seller can expect to recover upon taking possession and liquidating the devalued asset. The recovery rate is often defined as a percentage of the face value of the reference asset. (*Id*. at 4.)

Although a CDS may be settled by delivery of a security or by cash that references the value of the reference security, as the CFTC has explained, CDS are not designed to "transfer the price or value of a security from buyer to seller"; rather they are "instruments that isolate, measure and price credit risk." (Ex. A at 17.) CDS are not economic equivalents that are based on, or take on, the value of the debt instruments. Rather, as the CFTC has explained, these contracts "facilitate accurate pricing of related debt obligations by giving value to debt instruments." (*Id*.)

VI. Cleared CDS are "Commodity Contracts" Within the Meaning of the Bankruptcy Code Because They are Contracts of Sale of a Commodity for Future Delivery or Options on a Commodity

A. Cleared CDS That Reference an Index are Contracts for the Sale of A Commodity for Future Delivery

Cleared CDS are "commodity contracts" within the meaning of the Bankruptcy Code because they can be properly characterized as contracts of sale of a commodity for future delivery or commodity options, or an agreement similar to either.[3] *See* 11 U.S.C.A. §761(4). In both cases the commodity is the credit event whose occurrence triggers the seller's obligation to pay. CEA Section 1a(13) specifically includes within the definition of the term "excluded commodities" a "credit risk or measure" and certain occurrences or contingencies associated with financial, commercial or economic consequences, including changes in the price or value of credit risks or measures. Moreover, the definition of "commodity" in CEA Section 1a(4) is sweeping and includes anything that can be characterized as "services, rights and interests." Additionally, Article IV of the 2003 International Swaps & Derivatives Association's ("ISDA") *Credit Derivative Definitions* defines "credit events" as including: the bankruptcy of a reference entity; a reference entity's failure to pay on a debt; the repudiation of a debt obligations; a moratorium placed on debt obligation; the acceleration of the payment terms of a debt obligation; a default on a debt obligation; and restructuring the terms of debt obligation. Generally, bankruptcy, along with failure to pay and restructuring, is considered to be among the three most important trigger events for settling a CDS. *See* ISDA's News Release, September 19, 2006, *available at* http://www.isda.org/pree/press091906.html.

These considerations, as well as the design and features of the contracts described in Part V, *supra*, recently lead the CFTC to conclude that CME's credit index event contracts were contracts of sale of a commodity for future delivery, not options. (*See* Ex. A.) Specifically, the CFTC noted that CME's credit index event contract is a contract for the sale of a commodity for future delivery because it incorporates a payoff structure that is not dependant on a single occurrence. The contract's payoff structure, independent of gains and losses realized through trading, is dependant on the variable number of index reference entities that experience credit events. The credit index contract's payoff structure resembles that of a futures contract with an upward slope for a long position and a downward slope for a short position. (Ex. A at 15-16.)

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3 Cleared CDS contracts include features that place them at the border of futures and options. The usual categories do not neatly fit. Among other things, CDS contracts do not involve any strike prices and the buyer of protection is subject to an ongoing payment obligation of indefinite duration and amount. Upon payment of the premium, option buyers assume rights but no obligation; option sellers assume an opposite risk profile. Buyers and sellers of these credit default contracts enjoy no such optionality. The buyer of credit protection is obligated to make continuing payments, unless a credit event occurs, in which case the buyer has no further obligation.

We do not believe there is a material distinction between Cleared CDS that reference an index and CME's credit index event contract. Therefore, the Cleared CDS that reference an index are contracts of sale of a commodity for future delivery. Accordingly, they qualify as "commodity contracts" within the meaning of the Bankruptcy Code. *See* 11 U.S.C.A. §761(4)(A) & (F).

B. Non-Index Based Cleared CDS are Options Based on Commodities, Not Securities

Even if the non-index based Cleared CDS are not contracts of sale of a commodity for future delivery, they are still "commodity contracts" within the meaning of the Bankruptcy Code because they may be properly characterized as options on a commodity, or substantially similar to a commodity option.

The deliverable is not dispositive in determining whether the Cleared CDS are "commodity contracts" for purposes of the Bankruptcy Code. Indeed, an option on a weather event remains a commodity option regardless whether payment is accomplished by wire transfer of cash or delivery of a treasury bill. An option based on a hurricane pays off in dollars, not wind. That does not convert the option into an option on currency. It is an option on the occurrence of an event--landfall of a hurricane. In other words, the mode of payment does not change the nature of the option.

The relevant inquiry is how is the subject of an option properly identified and what is the subject of a CDS. This determination depends on purpose of the option, generally illustrated by the trigger event for payout. The event that triggers the option and permits it to be exercised is the relevant identifier. Ordinary equity options are triggered when the stock price crosses the strike price. As such, it is an option on the price of a security and therefore a security option. A CDS, in contrast, does not have a strike price. It is triggered by the occurrence of a credit event. Indeed, the SEC does not dispute the trigger event for payment. *See* SECURITIES AND EXCHANGE COMMISSION, (Release No. 34-57578; File No. S7-06-09) at 3, *available at* http://www.sec.gov/rules/exorders/2009/34-59578.pdf ("The obligation of a seller under a CDS to make payments under a CDS contract is triggered by a default or *other credit event* as to such entity or entities or such security or securities.") (emphasis added.)

The CFTC has explicitly found, to the extent that a CDS is an option, it is an option on the occurrence of the credit event and it is clear that a credit event is a "commodity" as defined in the CEA and the Bankruptcy Code. (CFTC Order dated January 31, 2007 ("Credit Event Order") attached hereto as Exhibit B.) The CFTC's determination was premised on the design and features of the contract described in Part V, *supra*. (*Id.*, January 26, 2007 Memorandum at 3-6.) Moreover, as with the credit index event contracts, although the CFTC concluded that credit risk events comfortably fell within the definition of "commodity" in the CEA, (Ex. B, January 26, 2007 Memorandum at 20-21,) it also considered the definition of "excluded commodity" in Section 1a(13)[4] in the CEA in determining that credit event contracts were options that transferred a commodity — credit risk— from the buyer to the seller.

In reaching this determination, the CFTC also considered relevant case law and further concluded that CME's credit event contracts were commodity options because they were *not* "economically equivalent" to securities of the reference entities. (Ex. B, January 26, Memorandum at 21-22.). The CFTC explained:

> At times, changes in the prices of debt securities can, in fact, be negatively correlated to the movement in the trading price of certain credit event contracts. This negative correlation would likely be most apparent for credit event contracts that contain terms that specifically reference credit events directly linked to an entity's debt obligations. That correlation, however, is not derived from the price or value of securities, and therefore it is reasonable to conclude that the contracts are not serving effectively as economic equivalents to securities. Option contracts on credit risk are not instruments designed to transfer the price or value of a security from buyer to seller. Rather, they are instruments designed to transfer credit risk, while excluding the other elements of price and value. Credit event contracts, isolate, measure, and price credit risk. By doing so, they are financial contracts that can facilitate the accurate pricing of related debt securities by giving value to debt securities, that is, by facilitating the discovery of the value of debt securities, as opposed to being the economic equivalents of debt securities that are based on and take on the value of debt securities.[5]

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[4] It is inconsequential that the phrase was included in the definition of "excluded commodity" rather than "commodity." "Excluded commodities are not themselves excluded from the CEA's coverage. Instead, these commodities are 'excluded' in the sense that they are eligible to be the underlying commodities for off-exchange contracts between certain sophisticated parties that are excluded from the [CEA]." (Ex B, January 12, 2007 Memorandum at 5.)

[5] Recognizing that options exist where the underlying involves both a commodity and a security, the CFTC took its analysis one step further and concluded that options on credit events were not also security options because credit risk or credit event can be found nowhere in the definition of "security" in securities laws, nor were they "based on the value thereof." (Ex. B, January 12, 2007 Memorandum at 6-7.) The CFTC reasoned that the absence of "credit risk" from the definition of "security" was compelling because the term was added to the CEA when amended by the CFMA but was not added to the definition of "security," which was amended contemporaneously with "excluded commodity, and concluded that Congress intentionally omitted "credit risk" from the definition of "security." (Ex. B, January 12, 2007 Memorandum at 7, *citing Keene Corp. v. United States*, 508 U.S. 200, 208 (1993) ("where Congress includes particular language in one section of a statute but omits it in another . . . , it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." (citation omitted).)

Although the credit event contracts at issue in the CFTC's Credit Event Order differ from Cleared CDS in that the payout value on the former was a pre-set value whereas the payout value on the Cleared CDS is not fixed in advance, this does not alter the conclusion that the Cleared CDS properly are characterized as commodity contracts for purposes of the Bankruptcy Code. Cleared CDS, like CME's credit event contracts, track the rise and fall of the probability that the triggering credit events will or will not occur. While changes in the price of the Cleared CDS could be correlated with changes in the price of the reference securities if the market perceives a significant change in the probability of a credit default, as the CFTC has recognized with respect to the CME's credit event contracts "at other times it is reasonable to expect that changes in the reference entity's securities would not be correlated, since non-credit related factors would drive the price changes in the reference entity's securities." (Ex. B, January 12, 2007 Memorandum at 12.) Such a relationship, or link, between the value of Cleared CDS and the value of the reference security is insufficient to find that Cleared CDS are options "based on" securities. (Ex. B, January 26, 2007 Memorandum at 23.)

C. Even if the Underlying Involves a Security, Cleared CDS are Not Exclusively Options Based on the Value of a Security

Even if the underlying of some Cleared CDS could be construed to involve a security because there could be a correlation between the change in price of the reference security and the change in price of Cleared CDS, that does not override the conclusion that they also involve a commodity, whether it be a credit risk event or financial occurrence. In the world of OTC derivatives, all kinds of hybrid instruments exist. In fact, the CFTC has acknowledged the existence of "options in which the underlying involves both a security *and* a commodity." (*See* Ex. B, January 12, 2007 Memorandum at 4.) As Judge Easterbrook explained in the *Chicago Mercantile Exchange* case: "If each agency's interpretation of its own statute is entitled to some deference, then the [contract] is both a security and a futures contract. It has some attributes of both, and all attributes of neither . . . . Neither characterization can be called wrong." *See Chicago Mercantile Exchange*, *supra*, 883 F.2d at 548.

The SEC has recently indicated that it considers OTC credit default swaps "security-based swap agreements" that are generally excluded from its jurisdiction, but takes the position that, once cleared, these instruments are considered securities for jurisdictional purposes because of the novation process. *See* SECURITIES AND EXCHANGE COMMISSION, (Release No. 34-57578; File No. S7-06-09) at 13 ("Absent an exemption, a CCP that novates trades of [Cleared] CDS that are securities and generates money and settlement obligations for participants is required to register with the Commission as a clearing agency.") While we believe that the SEC would take the position that a determination that Cleared CDS are options on both a commodity and a security would render them subject to the exclusive jurisdiction of the SEC, this jurisdictional determination does not alter these instruments' designation as "commodity contracts" within the meaning of the Bankruptcy Code. To be sure, the definition of "commodity contract" in Section 761(4) of the Bankruptcy Code does not limit qualifying options to those that are "exclusively" or "solely" on a commodity. *See* 11 U.S.C.A. §761(4).

On the contrary, the definition of "commodity contract" in the Bankruptcy Code is expansive and does not include limitations based on agency jurisdiction. If the commodity is held in a commodity account at an FCM it is a commodity contract. Subsection (F) provides that "any other agreement or transaction that is similar to an agreement or transaction referred to" in paragraph (4) is a commodity contract; subsection (G) provides that any combination of the agreements or transactions referred to in paragraph (4) is as well. The language in subsections (F) and (G) are included in the definitions of other instruments covered by the Bankruptcy Code, including swaps and securities contracts, and was added in 2005 "to provide sufficient flexibility to avoid the need to amend the definition as the nature and uses of [commodity transactions] matured." *See* H.R. REP. NO. 109-31, at 128.

Finally, Congress recognized that all of the Bankruptcy Code's definitions overlap considerably. *See* Morrison, E.R., Riegel, J., *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, at 15 n.79 (Columbia Law School, Center for Law and Economic Studies, Working Paper No. 291, 2006) (*citing* H.R. REP. NO. 109-31, at 131[6]). The 2005 amendment, which broadens the scope of definitions of the contracts covered by the Bankruptcy Code, signals an intent to expand the range of protections available to financial contract counterparties. *Id.* at 12. Thus, it would be consistent with this purpose for Cleared CDS in which the underlying involves both a commodity and a security to fall within the definition of "commodity contract" in the Bankruptcy Code.

VII. If The CEA Is Ambiguous, the CFTC's Determination That Credit Event Contracts Are Commodity Options and that Credit Index Event Contracts Are Contracts for the Sale of a Commodity for Future Delivery is Entitled To *Chevron* Deference

Even if it were determined that the CEA is silent or ambiguous as to whether options on credit events or occurrences are commodity options or whether contracts for the sale of a credit event or occurrence for future delivery are commodity futures, the CFTC's resolution regarding the classification of CME's credit event and credit index event contracts is entitled to deference

6 "The definition of 'financial participant' (as with the other provisions of the Code relating to 'securities contracts,' 'forward contracts,' 'commodity contracts,' 'repurchase agreements,' and 'swap agreements') is not mutually exclusive, i.e., an entity that qualifies as a 'financial participant' could also be a 'swap participant,' 'repo participant,' 'forward contract merchant,' 'commodity broker,' 'stockbroker,' 'securities clearing agency,' and/or 'financial institution.'" *Id*.

under *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.* because the interpretation is reasonable. 467 U.S. 837, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984).

Chevron stands for the proposition that administrative interpretations as to the meaning and reach of the statutes they are charged with enforcing that are reasonable are to be given controlling weight by courts. *Id*. at 844. The Supreme Court has held that *Chevron* deference is warranted even in the absence of a formal adjudication or rule-making. *See Barnhart v. Walton*, 533 U.S. 212, 221 122 S.Ct. 1265, 152 L.Ed.2d 330 (2002) ("And the fact that the Agency previously reached its interpretation through means less formal than 'notice and comment' rulemaking . . . does not automatically deprive that interpretation of the judicial deference otherwise its due.") Indeed, a federal court recently has granted *Chevron* deference where an agency employed administrative procedures that resemble those that official regulations undergo. *See, e.g., Miccosukee Tribe of Indians of Florida v. United States*, Civ. A. No. 08-10799, 2009 WL 1199871, at *13 (11th Cir. May 5, 2009) (finding that a handbook adopted by the Secretary of the Interior and the Fish & Wildlife Service, which are authorized by Congress to issue regulations that have the force of law in implementing the Endangered Species Act, was created following the same administrative procedures that official regulations undergo − it was published in the Federal Register and was adopted after a period for public comment − and therefore was entitled to deference under *Chevron*).

The CFTC is tasked with enforcing the CEA. Thus, to the extent that the CEA is deemed silent or ambiguous as to whether options on credit events or occurrences are commodity options or whether contracts for the sale of credit events or occurrences for future delivery are commodity futures subject to its jurisdiction, the CFTC certainly had authority to interpret the statute in determining whether it is responsible for regulating those instruments. Moreover, the Credit Event Order and Credit Index Event Order were issued following notice and an extensive comment period, and after rigorous analysis of the relevant issues had been employed by the Commission.[7] Finally, the CFTC's determination that credit event contracts are commodity options and that credit index event contracts are contracts for the sale of a commodity for future delivery cannot be considered anything other than a reasonable reading of the CEA for the reasons discussed herein. Accordingly, the CFTC's determination that credit risk or measure and certain occurrences or contingencies associated with financial, commercial or economic consequences, including changes in the price or value of credit risks or measures are "commodities" within the meaning of the CEA and its classification of contracts based on such commodities are to be given controlling weight.

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7 For this reason, *Commodity Futures Trading Commission v. Zelener* is inapposite. 373 F.3d 861 (7th Cir. 2004). In *Zelener*, the Court declined to grant *Chevron* deference to the CFTC's determination that rolling spot contracts were "futures" contracts subject to the CFTC's jurisdiction because the agency asserted this position *for the first time* in litigation.

VIII. If Cleared CDS Are Not Commodity Contracts They Are Still Protected By the Bankruptcy Code and Part 190 So Long As They Are Held In A 4d or 30.7 Account With Other Commodity Contracts of Such Customer

Even if Cleared CDS do not constitute "commodity contracts," the Cleared CDS that are held in a commodity futures account and all supporting customer property at the clearing house or FCM levels should be treated as a component of customer "net equity" within the meaning of the Bankruptcy Code and Part 190.

The CFTC recently addressed this issue in Interpretation 73 FR 65514 (November 4, 2008, attached hereto as Exhibit C):

> There is an alternative path to reach the same conclusion. In cases where cleared-only contracts are held in a commodity futures account at an FCM and margined as a portfolio with exchange-traded futures (*i.e.*, where the Commission has issued an order pursuant to section 4d(a)(2) of the Commodity Exchange Act), assets margining that portfolio are likely to be includable within ''net equity'' even if cleared-only contracts were found not to be ''commodity contracts'' within the meaning of the Bankruptcy Code and Part 190 of the Commission's Regulations.
>
> Where the assets in an entity's account margin (*i.e.*, collateralize) both cleared-only contracts and exchange-traded futures, the entirety of those assets serves as performance bond for each of the exchange-traded futures and the cleared-only contracts. Therefore, (a) a claim for those assets constitutes a claim ''on account of a commodity contract made, received, acquired, or held by or through such futures commission merchant in the ordinary course of such future commission merchant's business as a futures commission merchant from or for the commodity futures account of such entity;'' (b) the entity qualifies as a ''customer'' within the meaning of the Bankruptcy Code as a result of that claim; and (c) those margin assets are properly included within that entity's net equity.
>
> The dynamics of futures trading render it unwise to distinguish between an account that *currently* is portfolio margined and one that was at one time or is intended to be so in the future. Indeed, Subchapter IV of the Bankruptcy Code includes as customers entities with certain claims arising out of property that is not currently margining a commodity contract. Specifically, section 761(9)(A)(ii) provides that an entity can qualify as a ''customer'' based on claims arising out of any of the following: (I) The ''liquidation, or change in the value of a commodity contract;'' (II) a deposit of property ''for the purpose of making or margining … a commodity contract;'' or (III) ''the making or taking of delivery of a commodity

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

CONCLUSION

As discussed above, the jurisdictional disagreement among the CFTC and the SEC as to Cleared CDS is not relevant to determining whether customers are afforded special protections under the Bankruptcy Code. While certain features of the Cleared CDS may be determinative for jurisdictional purpose, this regulatory designation does not alter the hybrid-nature of these instruments. Indeed, as noted above, Congress considered the hybrid-nature of contemporary financial instruments in the 2005 amendments to the Bankruptcy Code, and in drafting the definitions of the various instruments covered by the Code, included sweeping language intended to provide as much protection as possible to as many market participants as possible.

We believe that the SEC would agree that customer funds in respect of Cleared CDS are entitled to protection under the Bankruptcy Code and Part 190 since the Exchange Act and its underlying rules and regulations, like the CEA and its underlying rules and regulations, is designed to "protect investors and promote market integrity." SECURITIES AND EXCHANGE COMMISSION, (Release No. 34-57578; File No. S7-06-09) at 27-28, *available at* http://www.sec.gov/rules/exorders/2009/34-59578.pdf. Indeed, the SEC recently explained the importance of the segregation of customer funds − which explanation assumed such funds would be afforded special status under the Bankruptcy Code − to investor protection:

> It is consistent with our investor protection mandate to require that intermediaries in securities transactions that receive or hold funds and securities on behalf of others comply with standards that safeguard the interests of their customers. For example, registered broker-dealers are required to segregate assets held on behalf of customers from proprietary assets, because segregation will assist customers in recovering assets in the event the intermediary fails. To the extent that funds and securities are not segregated, they could be used by a participant to fund its own business and could be attached to satisfy debts of the participant were the participant to fail.

SECURITIES AND EXCHANGE COMMISSION, (Release No. 34-57578; File No. S7-06-09) at 24, *available at* http://www.sec.gov/rules/exorders/2009/34-59578.pdf.