When Is a Trading Facility Not a Trading Facility Under The Commodity Exchange Act?

By Elizabeth L. Ritter

MORE THAN A YEAR AGO, the New York Mercantile Exchange ("NYMEX") began clearing a certain unique type of financial product involving options on crude oil and natural gas inventory statistics. What makes these particular options unusual (as opposed to standard exchange-traded options common to the NYMEX and other futures markets around the world) is the pricing system on which they are traded: the Longitude System® ("Longitude"), developed by a privately-held technology corporation and owned by the International Securities Exchange and Goldman Sachs, Inc., which have been offering these options for several years. Longitude utilizes a Dutch auction-like format, in which prices are derived through the use of a pari-mutuel pricing mechanism, resulting in executable option positions in either oil or natural gas inventory statistics.

At first blush, Longitude appears to be just another trading facility, albeit a sophisticated one, but a trading facility nonetheless. Market participants send in their bids and offers, which are either taken or rejected. Prices are derived from those bids and offers, and positions are entered on behalf of the participants. Certainly sounds like a trading facility . . . or does it?

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Enter the Commodity Exchange Act ("CEA"). The CEA provides the basic statutory framework used by the Commodity Futures Trading Commission ("CFTC") to oversee the commodity futures and options industry in the United States. In 2000, Congress amended the CEA in its promulgation of the Commodity Futures Modernization Act ("CFMA"), the most sweeping legislation affecting the derivatives markets since the inception of the CFTC in 1974. In that Act, Congress enacted statutory language to provide legal certainty for over-the-counter ("OTC") derivatives transactions in exempt and excluded commodities, and to provide regulatory relief for exchange-traded derivatives. The CFMA also amended the CEA to include several new definitions intended to effectuate these objectives, including definitions of the terms "excluded commodity," "exempt commodity," and "trading facility."[1]

Impact of the CFMA

By all accounts the CFMA has been a resounding success. The flexibility provided to market participants under this new regulatory oversight regime has resulted in unprecedented growth in on-exchange trading volume and product diversification, while at the same time, over-the counter markets have experienced remarkable increases in volume and profitability. In addition, the changes introduced by the CFMA have permitted unparalleled increases in the number of new entities seeking to trade derivatives products under alternative regulatory procedures.

This "supermarket" of regulatory choices is not, however, without detractions attendant to its virtues—the most obvious of which is confusion. For example, when you set out to buy a quart of cottage cheese and find that you are faced with a veritable cornucopia of choices, including small-curd, large-curd, low-fat, super-low-fat, 1%, 2%, and lactose-free, the results can be overwhelming and discouraging. Particularly when you get home and find that you have inadvertently purchased a quart of vanilla yogurt.

In an effort to provide some clarity for derivatives "shoppers," this article utilizes the current example of a novel financial platform to illustrate the many regulatory choices available under the CEA, and examines under what circumstances those choices may or may not be appropriate. Specifically, this article examines the oil and gas inventory statistics options trading under the Longitude system in light of the statutory provisions of the CEA, as amended by the CFMA, relating to 1) exclusions and exemptions for OTC derivatives; 2) regulatory relief for

exchange-traded products; and 3) new definitions in the CEA for commodities and trading facilities. The article concludes that regulatory relief for these transactions executed on the Longitude system is limited to only one of the new exemptive provisions provided by the CFMA.[2]

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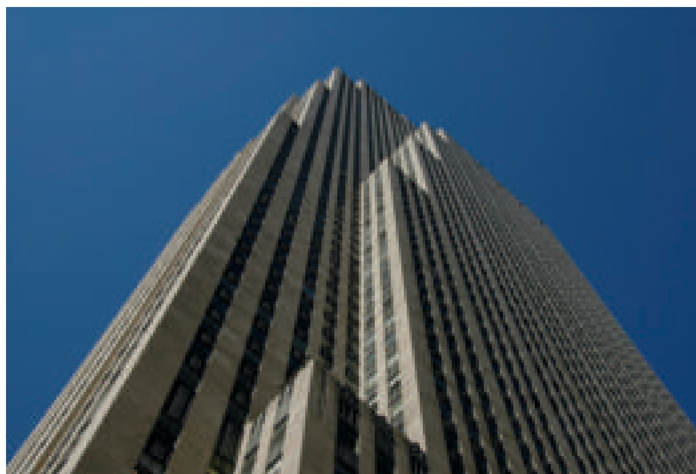
Legal Certainty Provisions of the CFMA

The CFMA amended the CEA to include new Sections 2(d), 2(g), and 2(h). These sections provide exclusions from regulation for excluded derivatives and excluded swaps, and exemptions for transactions in exempt commodities, respectively. Each provision has threshold requirements relating to the specific nature of the transactions and the underlying commodities, the entities on which they're traded, and the sophistication of the parties. These exclusions/exemptions are briefly described below.

Section 2(d), "excluded derivative transactions," provides a general exclusion from CFTC regulation for transactions in excluded commodities entered into between eligible contract participants ("ECPs"), not executed or traded on a trading facility. Additional regulatory relief is available under this provision if the transactions are executed on an electronic trading facility, on a principal-to-principal basis between ECPs trading for their own accounts or in a statutorily-defined agency capacity.



Section 2(g), entitled "excluded swap transactions," also provides a broad exclusion from CFTC regulation for swap transactions in excluded and exempt commodities, if the contract, agreement, or transaction is entered into by ECPs, subject to individual negotiation, and not executed or traded on a trading facility.

Section 2(h), "legal certainty for certain transactions in exempt commodities," provides two levels of exemptive regulatory relief for transactions in exempt commodities. First, Section 2(h)(1) provides that nothing in the Act, other than antimanipulation and certain antifraud provisions, applies to transactions in exempt commodities between ECPs, not entered into on a trading facility. Second, Section 2(h)(3) provides a similar exemption for exempt commodity transactions, as long as they are entered into between eligible commercial entities on a principal-to-principal basis, and executed on an electronic trading facility.

New Definitions Included in the CFMA

Germane to this discussion are three new definitions included in the CEA, as amended by the CFMA. They are briefly described, as follows:

1. **Excluded Commodity.**[3] The definition of "excluded commodity" in the CEA includes four subsections, each of which provides substantively different classifications and standards for assessing qualification as an excluded commodity. The first subsection catalogs specific types of commodities that are commonly considered to be financial commodities (for example, interest rates, exchange rates, and debt or equity instruments). The second subsection consists of risk measures that are not based on a narrow group of commodities, or measures that are based on commodities with no cash market (for example, an index including a broad range of commodities). The third subsection addresses indices based on prices, rates values or levels not within the control of relevant parties to the transaction (for example, a housing price index or aconsumer price index). Lastly, the fourth subsection includes occurrences or contingencies that are beyond the control of the parties to the contract and are associated with some financial, commercial or economic consequence (for example, weather derivatives).
2. **Exempt Commodity.**[4] The CEA, in a peculiar bit of legislative draftsmanship, describes an exempt commodity by a negative: it is that which is neither an excluded commodity nor an agricultural commodity. As noted in the preceding paragraph, Congress provided a comprehensive (if prolix) definition of an excluded commodity, and the term agricultural commodity has the benefit of a longstanding CEA definition, as well as the common sense understanding of what it means to be an agricultural

commodity. This leaves the exempt commodity field to mean, one supposes, everything else.

❸ **Trading Facility Definitions.** The CFMA amended the CEA to include a specific definition of "trading facility." The genesis for this definition was, at least in part, driven by the rise of electronic trading platforms and the desire to provide clarity for market participants as to what constitutes an entity that falls under CFTC jurisdiction. Specifically, the CEA now provides that a trading facility means a person or group of persons that constitutes, maintains, or provides a physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements, contracts, or transactions by accepting bids and offers made by other participants that are open to multiple participants in the facility or system.[5]

The definition also provides for certain exceptions: 1) electronic facilities that enable participants to negotiate terms of and enter into bilateral transactions as a result of communications between the parties, and not from the interaction of multiple bids and offers within a "predetermined, nondiscretionary automated trade matching and execution algorithm"; 2) government securities broker/dealers, to the extent that such entities execute or assist in the execution of government securities transactions; and 3) facilities on which bids and offers, and acceptances of bids and offers, are not binding. The definition specifically provides that clearing of transactions entered into on an entity not otherwise considered a trading facility does not alter the characterization of the entity.

In addition, the CFMA also included a separate definition for "electronic trading facility"[6] which includes "a trading facility that . . . operates by means of an electronic or telecommunications network" and "maintains an automated audit trail of bids, offers, and the matching of orders or the execution of transactions on the facility."

Lastly, the CFMA amended the CEA to include a definition of the term "board of trade."[7] Specifically, "board of trade" means "any organized exchange or other trading facility"; "organized exchange," in turn, is defined as a "trading facility" that has certain specified characteristics.[8]

Regulatory Relief Provisions of the CFMA

The CFMA instituted a tiered system of market regulation, tailored to particular market requirements. The first level of regulation relates to "designated contract markets" ("DCMs")[9] — what most people think of when they think of a futures market exchange, for example the NYMEX or the Chicago Board of Trade. These markets are open to all market participants (retail investors as well as sophisticated institutional investors), and trade in all commodities. As opposed to the prescriptive, one-size-fits-all rules in place prior to the CFMA, DCMs are subject to 18 "core principles" that ensure the markets provide appropriate oversight of trading to protect against fraud and manipulation and to protect the integrity of the marketplace and the transactions executed in the marketplace. The second "tier" of CEA market regulation relates to "derivatives transaction execution facilities" ("DTEFs"), which are limited to ECPs and certain others trading through large futures commission merchants; there are limitations on the commodities that may be traded on these platforms.[10] DTEFs are subject to eight core principles that address market integrity and customer protection issues, tailored to the nature of the market participants and the commodities traded on the facility.

The third level of market oversight instituted under the CFMA is the "exempt board of trade" ("EBOT") and the "exempt commercial market" ("ECM").[11] Section 5d allows a "board of trade," upon notice to the Commission, to operate as an EBOT if: 1) it trades only in commodities that have a nearly inexhaustible supply, a deliverable supply that is sufficiently large, and a cash market sufficiently liquid, such that trading in the commodity is highly unlikely to be susceptible to manipulation, or no cash market;[12] and 2) trading is limited to ECPs. This provision thus operates essentially as an additional exemption from CFTC regulation; there are no core principles for EBOTs, though EBOT transactions do remain subject to the CEA's prohibitions against fraud and manipulation. With regard to ECMs, Section 2(h) of the CEA provides regulatory relief for transactions in exemption commodities, as discussed in greater detail below.

Discussion of Natural Gas and Crude Oil Statistic Options

To get back to the original question, how does the trading of options on natural gas and crude oil inventory statistics on the Longitude system fit into the new regulatory structure and definitions described above? Under what regulatory exclusions or exemptions from the CEA—2(d) excluded derivative transactions, 2(g) excluded swap transactions, 2(h) exempt commodity transactions, or 5d EBOT transactions—if any, are these options executed? The key to untying this Gordian knot of statutory provisions begins with identification of the parties to the transactions, the commodities traded, and lastly, the nature of the facility on which the transactions are executed.

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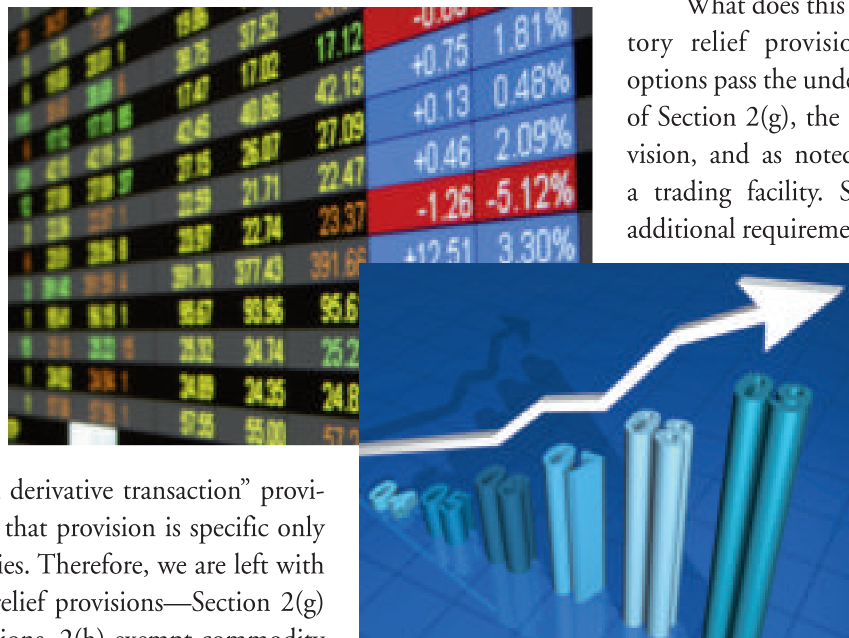
The first query is by far the easiest. These transactions are limited to ECPs, one of the threshold requirements for each of the legal certainty requirements discussed above. So as to the first test—participant sophistication—all of the cited regulatory relief provisions would be applicable.

We lose one of these relief provisions when we move on to our second inquiry: identifying the nature of the commodities traded. Crude oil and natural gas inventory statistics options would appear to fall under the exempt commodity category, inasmuch as they do not meet any of the four subsections of the excluded commodity definition,[13] and they certainly are not agricultural commodities. Therefore, by definition, they must be exempt commodities. The nature of the underlying commodity limits the nature of the regulatory relief available under the CEA: the Section 2(d) "excluded derivative transaction" provision is inapplicable, as that provision is specific only to excluded commodities. Therefore, we are left with only three regulatory relief provisions—Section 2(g) excluded swap transactions, 2(h) exempt commodity transactions, and 5d EBOT transactions— all of which are potentially available for exempt commodity transactions,[14] as we turn to our last area of inquiry.



Our final query, to determine potential regulatory relief under the CEA, relates to the nature of the transaction facility. Sections 2(g) and 2(h)(1) share the same requirement that the transactions not be executed on a "trading facility."[15] Section 2(h)(3), by contrast, requires that the transactions be executed on an "electronic trading facility." Accordingly, whether Longitude is a "trading facility" is critical to a determination of where the entity falls on the CEA's regulatory landscape.

The CEA defines a trading facility as a "physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements, contracts, or transactions by accepting bids and offers made by other participants that are open to multiple participants in the facility or system."[16] Longitude does not appear to be a system that permits such "multiple" bid and offer participation. Indeed, it would seem that once the system sets option prices using the pari-mutuel pricing system, Longitude operates as a "dealer" system, with the dealer as the buyer to every option seller and the seller to every option buyer on the system. There is no indication that there is matching of orders on the system: it appears that all orders are entered into with a central counterparty, rather than with "multiple participants" on the opposite side of transactions. Therefore, inasmuch as participants would not appear to be "accepting bids and offers made by other participants," but rather all orders seem to be entered into with a single central counterparty, this system would not act to match orders among "multiple participants" as contemplated under the CEA's statutory definition of a trading facility. Accordingly, it follows that Longitude is not appropriately considered a "trading facility" within the meaning of the CEA.

What does this mean for our remaining regulatory relief provisions? The inventory statistics options pass the underlying commodity requirement of Section 2(g), the excluded swap transaction provision, and as noted the Longitude system is not a trading facility. Section 2(g), however, has an additional requirement: that the transactions be subject to individual negotiation. The Longitude system doesn't allow for such negotiation; bids and offers are entered into the system and are either accepted or rejected, and no individual negotiation of terms is available to the parties on the system. Therefore, while we made it down to the wire with this one, like Lucy pulling the football away just as Charlie Brown is ready to kick, we're forced to conclude that transactions on the Longitude system do not meet the statutory requirements for exclusion under Section 2(g) of the CEA, and regulatory relief is not available under that statutory provision.

As for Section 2(h) exempt commodity transactions, Section 2(h) distinguishes between those transactions in exempt

commodities that are not conducted on a trading facility—Section 2(h)(1) transactions—from those conducted on an electronic trading facility—Section 2(h)(3) transactions. It goes without saying that since Longitude is not a "trading facility," it cannot be considered an "electronic trading facility" under the CEA, inasmuch as the latter utilizes the former as a premise in its definition. Therefore, trading on the Longitude system fails to meet one of the requirements of Section 2(h)(3), that transactions be executed on an electronic trading facility; accordingly, exemptive relief is not available pursuant to that provision.[17] That leaves us with Section 2(h)(1).

Crude oil and natural gas inventory statistics options executed on the Longitude system appear to satisfy the requirements of CEA Section 2(h)(1). The transactions are entered into between ECPs and are not executed or entered into on a trading facility. Accordingly, it would appear that market participants could rely on this exemption in the CEA in the execution of these transactions. No notification to the CFTC is required pursuant to this section; the provision is self-effectuating. Finally, we've come across a provision of the CEA that affords regulatory relief to the crude oil and natural gas options transactions executed on the Longitude system.

If Section 2(h)(1) did not afford the sought-after regulatory relief, the Longitude system would be out of luck, because the only oversight provision left to review—CEA Section 5d EBOTs—isn't going to get us very far. Although the Longitude system meets the participant and commodity criteria for EBOTs under CEA Section 5d, because it is not a trading facility this provision is not appropriate for transactions executed on Longitude. The EBOT provision begins with the words "[a] board of trade . . . ." As noted above, the definition of "board of trade" is an "organized exchange" or other "trading facility." The definition of "organized exchange" under the CEA means a "trading facility." A board of trade, therefore, must be a trading facility, and we have already determined that Longitude is not a trading facility under the CEA; accordingly, Longitude does not qualify as an EBOT.

Conclusion

The CFMA amended the CEA to provide market participants with numerous choices in the regulatory arena for commodity futures and options. To the extent that the CEA appears to provide rather too many choices in some instances, this article has attempted to outline a method to navigate the numerous and complex regulatory relief provisions of the CEA. As to the specific transactions discussed—options on crude oil and natural gas inventory statistics traded on a platform that does not constitute a trading facility under the CEA—only one statutory provision, Section 2(h)(1), appears to provide self-effectuating regulatory relief from many of the provisions of the CEA. The Longitude system also does not qualify for regulatory relief as an EBOT in these circumstances inasmuch as these entities presumptively must be trading facilities under the CEA. BLB

Deputy General Counsel, United States Commodity Futures Trading Commission. The opinions expressed in this article are solely those of the author, and are not intended in any way to represent the views of the Commission or any of its Divisions or Offices.

ENDNOTES: *Elizabeth L. Ritter*

1 CEA, 7 U.S.C. § 1a(13), (14), (33) (2003).

2 The brief walk through some of the CFMA's key exclusions, exemptions, and definitions in this article should not mask the difficulty inherent in parsing these statutory provisions. These are complex, sometimes overlapping provisions; their meaning, and the ways in which Congress intended them to be interpreted (each in turn and in tandem with the others) is rarely self-evident.

3 CEA Section 1a(13), 7 U.S.C. §1a(13).

4 CEA Section 1a(14), 7 U.S.C. §1a(14).

5 CEA Section 1a(33), 7 U.S.C. §1a(33).

6 CEA Section 1a(10), 7 U.S.C. §1a(10).

7 CEA Section 1a(2), 7 U.S.C. §1a(2).

8 CEA Section 1a(27), 7 U.S.C. §1a(27).

9 CEA Section 5, 7 U.S.C. §7.

10 CEA Section 5a(b)(2), 7 U.S.C. §7a (requiring that commodities traded on a DTEF generally have "nearly inexhaustible deliverable supply" and be "highly unlikely to be susceptible to the threat of manipulation."). In addition, there is a commercial trading subset included in this provision, allowing trading in commodities other than enumerated agricultural commodities (except as provided in Section 5(e)(2)), and requiring that trading be limited to eligible commercial entities trading for their own account. CEA Section 5a(b)(2)(F), 7 U.S.C. § 7a(b)(2)(F).

11 CEA Section 5d, 7 U.S.C. §7a-3; CEA Section 2(h), 7 U.S.C. §2(h).

12 CEA Section 5d(b)(3), 7 U,S,C, §7a-3 (specifying that no trading in futures securities are permitted on EBOTs). Part 36 to the CEA Regulations states specifically that excluded commodities are eligible to be traded on EBOTs (Reg.36.2(a)(2)(i)). In addition, the CFTC has issued orders pursuant to Reg. 36.2(a)(2)(ii) permitting other types of commodities to be traded on EBOTs.

13 *See supra* note 3 and accompanying text.

14 CEA §5d, 7 U.S.C. § 7a-3 (explaining that determination of whether the underlying commodity test of Section 5d is satisfied is dependent upon whether the exempt commodities can meet the criteria listed in Section 5d(b)(1)(A) – (C) relating to nearly inexhaustible deliverable supply, non-susceptibility to manipulation, or lack of a cash market). There is a question as to whether excluded commodities generally, and excluded energy commodities in particular, could ever satisfy these criteria; the author makes no prognostication in this regard.

15 This overlap has created some statutory ambiguity as to whether the exclusion in Section 2(g) somehow "trumps" the exemption of Section 2(h)(1) and the latter's reservation of CFTC enforcement authority (such as antifraud and antimanipulation authority) with respect to transactions in energy commodities. The better answer appears to be that it does not, as it is an accepted canon of statutory construction that the statute shall not be construed in such a manner as would render any portion of the statute superfluous. Williams v. Taylor, 529 U.S. 362. 364 (April 18, 2000).

16 CEA § 1a(33)(A), 7 U.S.C. § 1a(33)(A).

17 It should be noted that trading on the Longitude system, inasmuch as it is not limited to eligible commercial entities, would fail to pass the requirements of CEA Section 2(h)(3) for that reason, in addition to failing to meet the trading facility requirement.