UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

CARY OIL CO., INC., et al., Plaintiff, -against- MG REFINING & MARKETING, INC., et al., Defendant.	99 Civ. 1725 (VM) (DFE)

MEMORANDUM OF LAW OF INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., SECURITIES INDUSTRY ASSOCIATION AND THE BOND MARKET ASSOCIATION, AS *AMICI CURIAE*, IN SUPPORT OF PLAINTIFFS' OBJECTIONS TO MAGISTRATE JUDGE EATON'S REPORT AND RECOMMENDATION TO JUDGE MARRERO

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The International Swaps and Derivatives Association ("ISDA"), the Securities Industry Association ("SIA") and The Bond Market Association (the "BMA") submit this amicus memorandum of law in support of plaintiffs' Limited Objections to the January 4, 2002 Report and Recommendation to Judge Marrero regarding Defendant's Motion for Summary Judgment (the "Objections").

PRELIMINARY STATEMENT

In 1995, the Commodity Futures Trading Commission (the "CFTC") entered an Order against defendant MG Refining & Marketing, Inc. ("MG"), finding that MG had violated the Commodity Exchange Act (the "CEA") by entering into contracts that the CFTC held were off-exchange futures contracts that violated Section 4(a) of the CEA. In reliance on that Order, MG thereafter sought to repudiate its substantial contractual obligations to numerous third parties to whom MG had marketed the contracts that it had designed.

Defendant's conduct and the implications of the CFTC's Order and 1998 actions, among other things, prompted Congress to enact the Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000) (the "CFMA"). The CFMA amended the CEA, in particular Section 25 thereof, specifically to eliminate the legal uncertainty regarding the enforceability of OTC derivatives agreements. Congress mandated such contracts were enforceable and could not be voided or rescinded.

When Congress initially enacted Section 25 of the CEA in 1983, it provided in Section 25(d) that Section 25 applied to all causes of action that accrued on or after enactment of the Futures Trading Act of 1982, i.e., January 11, 1983. When Congress enacted the CFMA and added Section 25(a)(4), it did not modify Section 25(d) or otherwise exempt Section 25(a)(4)

from this provision. Indeed, to have done so would have meaningfully vitiated the protection that Section 25(a)(4) provided to the financial markets.

This action calls directly into question whether Section 25(a)(4) is retroactive in its effect. On January 4, 2002, in response to defendant's motion for summary judgment, Magistrate Judge Eaton issued his Report and Recommendation to Judge Marrero (the "Report"). Despite the objectives of the CFMA, Magistrate Judge Eaton erroneously concluded that Section 25(a)(4) did not retroactively apply to contracts entered and breached prior to enactment of the CFMA. This recommendation is contrary to both the plain language of Section 25(a)(4), as well as the legislative history of the CFMA. Moreover, adoption of that recommendation would reestablish to a large degree the very uncertainty that Congress chose to eliminate. Consequently, the Court should not accept the Magistrate Judge's recommendation, and should hold that Section 25(a)(4) applies to causes of action accruing on and after the date of enactment of the Futures Trading Act of 1982.

STATEMENT OF INTEREST

ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry, a business that includes interest rate, currency, commodity, credit and equity swaps. ISDA was chartered in 1985, and today numbers over 550 member institutions from 41 countries on six continents. These members include most of the world's major institutions who deal in, and are leading end-users of, privately negotiated derivatives, as well as associated service providers and consultants. Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. ISDA devotes its efforts, among other things, to advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

SIA represents the interests of nearly 700 securities firms that engage in all phases of corporate and public finance in United States and foreign markets. It routinely monitors and comments on proposals that impact the business interests of those firms. More than a decade ago, SIA formed a Derivative Products Committee to represent the interest of its member firms with respect to activities involving swaps and related derivatives products across the interest rate currency, commodity and equity markets. Since that time, SIA has been an active participant in legislative and regulatory developments affecting that segment of the capital markets.

The BMA represents securities firms and banks that underwrite, trade and sell fixed-income securities in the both the United States and international markets. The BMA's members routinely engage in a wide variety of both exchange-traded and over-the-counter derivatives contracts. Among the BMA's functions is to monitor legislative and regulatory developments affecting the bond industry and to educate legislators and regulators about issues affecting the industry.

Because of their roles in the development and maintenance of derivatives markets, these three institutions are uniquely positioned to evaluate and comment on the Magistrate Judge's recommendation regarding the application of Section 25(a)(4) as well as its consequences. Indeed, the amici each actively participated in the proceedings before Congress both before and in connection with the enactment of the CFMA concerning issues affecting the derivatives markets. During the time that the CFMA was being considered by Congress, the amici, along with the financial community generally, identified the enforceability of privately negotiated OTC derivatives transactions as a key issue that needed to be addressed in any reform package.

The recommendation in the Report would fundamentally undermine the legal certainty that the CFMA explicitly provides to market participants. The recommendation would

enable counterparties to repudiate, or threaten to do so, many OTC derivative transactions that were made prior to enactment of the CFMA. As a consequence, the efficient working of United States financial market would be placed at risk, affecting not only the members of each of the three amici, but also the competitive position of the United States in the global financial market. Congress did not contemplate such a result, and plaintiffs' objections to the recommendation should be sustained.

ARGUMENT

POINT I

THE CLEAR INTENT OF CONGRESS WAS TO APPLY SECTION 25(a)(4) TO TRANSACTIONS ENTERED INTO PRIOR TO ENACTMENT OF THE CFMA

The enactment of the CFMA was the culmination of the concerted efforts of many parties, including the three amici, to reform the CEA and to eliminate the legal uncertainty that threatened the viability of the derivatives market in the United States. Congress expressly stated the statutory purpose of the CFMA was, in part, "to promote innovation for futures and derivatives and to reduce systemic risk by enhancing legal certainty in the markets for certain futures and derivatives transactions." CFMA, § 2, Pub. L. No. 106-554, 114 Stat. 2763 (2000). In doing so, Congress addressed a growing concern that the regulatory safe harbors and exemptions under the CEA that provided relief for qualifying privately negotiated OTC derivatives transactions from the CEA and regulation by the CFTC had been substantially undercut by certain CFTC actions.[1]

[1] This amici curiae memorandum does not repeat the case law cited in the Objections regarding the importance of legislative history in construing the CFMA. It relies on and incorporates those citations. See Objections at 4-6.

Absent an exemption or exclusion, transactions deemed to be futures contracts not traded on a CFTC-regulated exchange could be held to be illegal under the CEA, as the CFTC did in the MG Order. Prior to the enactment of Section 25(a)(4), that risk was a real one. Actions by the CFTC raised significant concerns about the legal certainty concerning the enforceability of OTC derivatives transactions and thereby increased the risk that a counterparty could challenge these transactions as illegal, off-exchange futures contracts and thus walk away from their losses under them. The CFMA is the result of the concerted efforts of many to eliminate that uncertainty.

A. The Efforts Preceding Enactment of the CMFA

In the 1990s, there was meaningful uncertainty as to whether the CFTC would assert that OTC derivatives transactions constituted illegal futures transactions under the CEA. That uncertainty threatened the vibrancy of the derivatives market in the United States, and had to be addressed. During that time, the derivatives industry, as well as the amici, worked to achieve that result.

Initially, in 1989, at the prompting of the amici and other industry participants, the CFTC issued a policy statement creating a non-exclusive "safe harbor" for swaps transactions. See 54 Fed. Reg. 30,694, 30,694 (July 21, 1989). In that policy statement, the CFTC observed "at this time most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the Act and regulations." That policy statement, which was merely an expression of views lacking the force of law, did not include numerous other types of derivatives products, such as interest rate option products. Issues relating to these other products were incrementally addressed over time, but the uncertainties remained.

In 1992, Congress enacted the Futures Trading Practices Act of 1992, Pub. L. No. 102-546, 106 Stat. 3590, again at the prompting of industry participants, in order to address the concerns regarding the legal status and enforceability of OTC derivatives transactions. Although the statute did not address whether a derivatives transaction constitutes a futures contract, the statute authorized the CFTC to exempt derivatives transactions from the CEA, without having to address that issue. Congress' purpose in enacting this provision was "to give the [CFTC] a 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." H.R. Rep. No. 978, 102d Cong., 2d Sess. at 81 (available on LEXIS at 102 H. Rpt. 978) (1992). In accordance with the statute, in early 1993, the CFTC adopted a Swaps Exemption along the lines of the 1998 policy statement. 58 Fed. Reg. 5581 (Jan. 22, 1993) (adopting Part 35 Rules). The 1992 statute and the 1993 Swaps Exemption did not eliminate all uncertainty, but they appeared to provide stability in the market. That stability, however, was substantially undermined by subsequent acts of the CFTC and the dramatic increase in the use of securities-based derivatives, which did not benefit from the scope of the 1993 Swaps Exemption.

First, the CFTC's 1995 Order against MG raised concerns because its extremely broad description of a futures contract could embrace virtually any type of OTC derivatives transaction.[2] The anxiety arising out of that Order was not unfounded, as reflected by MG's

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[2] In December 1995, the Chairmen of the House Agriculture and Commerce Committees sent a letter to the CFTC voicing concerns about the MG Order and the appearance that the CFTC no longer supported the views set forth in the 1989 policy statement, and they requested clarification. See Letter from Pat Roberts and Thomas J. Bilkey, Jr. to Commodity Futures Trading Commission, dated December 15, 1995. The Chairman of the CFTC promptly responded, stating that the CFTC had not changed its position, and recognizing the need to provide legal certainty to the United States' derivatives markets. See Letter from Mary L. Shapiro to Honorable Pat Roberts and Honorable Thomas J. Bilkey, Jr., dated January 19, 1996.

efforts in this action and others to use the Order as a means to repudiate binding legal obligations that had become unprofitable for MG.

Second, in 1998, in a comment letter and a concept release, the CFTC once again suggested that it was abandoning the 1989 policy statement. The CFTC indicated that it was contemplating exercising authority over derivatives transactions. See Over-the-Counter Derivatives, 63 Fed. Reg. 26,114 (May 12, 1998). The CFTC's pronouncements provoked great concern. At congressional hearings in the summer of 1998, representatives from ISDA and the SIA testified as to the legal uncertainty that would be created by the CFTC's attempts to assert authority over derivatives transactions. Similarly, the United States Treasury, the Federal Reserve Board and the SEC also expressed their concerns. As a consequence, Congress enacted a moratorium, and limited the CFTC's rule making authority. See Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act, 1999, § 760, as enacted in Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999, Pub. L. No. 105-277, 112 Stat. 2681, 2681-35 (1998).

In response to Congress' request that the President's Working Group on Financial Markets (the "Working Group") develop a coherent policy with respect to derivatives transactions, see Over-the-Counter Derivatives Markets and the Commodity Exchange Act, Report of the President's Working Group on Financial Markets at 1 (Nov. 1999) (the "Working Group's Report"), in November 1999, the Working Group delivered its report. In the accompanying letter to Speaker Hastert, the Working Group stated: "A cloud of legal uncertainty has hung over the OTC derivatives markets in the United States in recent years, which, if not addressed, could discourage innovation and growth of these important markets and damage U.S. leadership in these arenas by driving transactions off-shore." Id., Letter dated November 9, 1998 to Honorable J. Dennis Hastert at 1. Following the suggestions advocated by

the amici and other industry participants, the Working Group recommended that several changes be made to the CEA. Id. at 15-18. To address the continuing legal uncertainties, the Working Group recommended that: "The CEA should be amended to clarify that a party to a transaction may not avoid performance of its obligations under, or recover losses incurred on, a transaction based solely on the failure of that party (or its counterparty) to comply with the terms of an exclusion or exemption under the CEA." Id. at 18.

B. The CFMA and Its Legislative History

As a consequence of the Working Group's Report, Congress began to consider and develop various legislative proposals that resulted in the enactment of the CFMA in December 2000.

After extensive hearings, see H.R. Rep. No. 106-711, Part 1, at 41-44 (June 29, 2000) (available on LEXIS at 106 H. Rpt. 711), the House Committee on Agriculture reported the first version of the bill that ultimately became the CFMA. The committee's report stated:

> The [Working Group's Report] concluded that bilateral swap agreements entered into by eligible parties (large and/or sophisticated) and done on a principal-to-principal basis should be excluded from the CEA. The report also stated the [Working Group's] belief that these agreements be allowed on certain electronic trading systems that should be excluded from the CEA and that clearing for these products should be encouraged to prevent systemic risk.
>
> H.R. 4541 implements the [Working Group] recommendations listed in the prior paragraph.

Id. at 28. After noting that development of the financial markets in the United States were being hampered because of the uncertain regulatory environment, id. at 31, the committee observed that, under its proposed bill: "Legal certainty for swaps and other OTC derivatives is secured . . ." Id. at 32.

Two and one-half months later, the House Committee on Banking and Financial Services issued its own report.[3] It stated:

> Legal uncertainty for derivatives has for years been of particular concern to the Committee. Outdated statutes that raise questions about the enforceability of contracts with banks and bar improvements in the way banks reduce risk pose a palpable threat to the safety and soundness of the financial system. U.S. banking regulators warn that uncertainties and unintended consequences associated with the CEA could potentially turn financial disruptions in the global system into financial disasters.

H.R. Rep. No. 106-711, Part 2 at 54 (Sept. 6, 2000) (available on LEXIS at 106 H. Rpt. 711). The Banking Committee acknowledged the work of the Working Group, and stated that the Working Group's Report "made a number of legislative recommendations to clarify that certain off-exchange transactions are not subject to the CEA. H.R. 4541, as reported by the Committee on Agriculture, implements the [Working Group's] legislative recommendations. The Banking Committee amendment builds on the [Working Group's] recommendations by expanding the kinds of derivatives transactions that are excluded from the CEA and, thus, provides legal certainty." Id. at 55.

On that same date, the House Committee on Commerce issued its report. As a result of its hearings, the committee stated: "Testimony provided to this Committee, as well as other committees of both the House and Senate, demonstrated widespread agreement that greater legal certainty under the CEA for over-the-counter derivatives transactions would be beneficial for further development of these products. To help achieve greater legal certainty for over-the-counter transactions, the legislation excludes from the CEA financial derivatives

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[3] At the hearings before the Banking Committee, the committee heard testimony from, among others, ISDA, the American Banking Association, the Association for Financial Professionals and each of the agencies represented in the Working Group. See H.R. Rep. No. 106-711, Part 2 at 57-58 (Sept. 6, 2000).

contracts traded off-exchange by eligible contract participants." H.R. Rep. No. 106-711, Part 3 at 47 (Sept. 6, 2000) (available on LEXIS at 106 H. Rpt. 711).

The Senate Committee on Agriculture, Nutrition and Forestry acted simultaneously, and issued its report on August 25, 2000. That report noted that the Senate legislation adopted many of the Working Group's recommendations, thereby "ensuring that legal certainty is attained and that certain transactions remain outside the CEA." S. Rep. No. 106-390 at 3 (Aug. 25, 2000) (available on LEXIS at 106 S. Rpt. 390).

While Congress was considering the reported bills, a group of industry associations, including the amici, sent a letter, dated October 18, 2000, to J. Dennis Hastert, Speaker of the House of Representatives, and Richard Gephardt, Minority Leader of the House of Representatives. See Letter from Ad Hoc Coalition of Commercial and Investment Banks, The Bond Market Association, Emerging Markets Traders Association, The Foreign Exchange Committee, Futures Industry Association, International Swaps and Derivatives Association, and Securities Industry Association to the Honorable J. Dennis Hastert and the Honorable Richard Gephardt, 146 Cong. Rec. E 1939 (Oct. 18, 2000), LEXIS Cong. Rec. E1939 (the "Industry Letter"). In the Industry Letter, the group strongly urged Representatives Hastert and Gephardt and their colleagues to support the CFMA, and stated that the "legislation would provide 'legal certainty' that over-the-counter (OTC) derivatives will continue to be enforceable in accordance with their terms." Id. at E 1939-40.

On December 15, 2000, the House of Representatives and the Senate enacted the CFMA after it was reported out of conference. The CFMA was signed by the President on December 21, 2000.

C. The Statute

The text of the CFMA itself makes evident Congress' intention to eliminate for all purposes and in all respects the cloud of uncertainty that threatened the viability and growth of the derivatives market in the United States.

Section 103 of the CFMA is entitled "Legal Certainty for Excluded Derivatives Transactions." Section 103 amended Section 2 of the CEA to provide that it does not govern or apply to an agreement, contract or transaction for derivatives transactions involving various excluded commodities.

Section 120 of the CFMA, entitled "Contract Enforcement Between Eligible Counterparties", amended Section 25(a) to ensure that OTC derivatives transactions are enforceable. Congress added subsection (a)(4) to Section 25, and that subsection provides:

> (a) Actual damages; actionable transactions; exclusive remedy.
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> (4) Contract enforcement between eligible counterparties. No agreement, contract, or transaction between eligible contract participants or persons reasonably believed to be eligible contract participants, and no hybrid instrument sold to any investor, shall be void, voidable, or unenforceable, and no such party shall be entitled to rescind, or recover any payment made with respect to, such an agreement, contract, transaction, or instrument under this section or any other provision of Federal or State law, based solely on the failure of the agreement, contract, transaction, or instrument to comply with the terms or conditions of an exemption or exclusion from any provision of [the CEA] or regulations of the [CFTC].

7 U.S.C. § 25(a)(4)(2001).

Congress could have placed this provision any place in the CEA. As the text of the bill corroborates, Congress deliberately chose to place it within Section 25. That choice is significant. Congress' placement of subsection (a)(4) means that Congress made it subject to the effective date provision in Section 25.

When Congress amended Section 25 to add subsection (a)(4), it did not remove, amend or restrict the application of the existing subsection in Section 25 that governs the effectiveness of that section in its entirety. That provision, Section 25(d), expressly provides:

> Dates of application to actions. The provisions of this section shall become effective with respect to causes of action accruing on or after the date of enactment of the Futures Trading Act of 1982: Provided, That the enactment of the Futures Trading Act of 1982 shall not affect any right of any parties which may exist with respect to causes of action accruing prior to such date.

7 U.S.C. § 25(d) (2001) (emphasis added; parentheticals omitted). Thus, under the express language of Section 25(d), the legal certainty provision contained in Section 25(a)(4) is effective with respect to causes of action accruing on or after January 11, 1983, the date of enactment of the Futures Trading Act of 1982.

Because Section 25 contains express language that applies Section 25(a)(4) to causes of action that have accrued prior to enactment of the CFMA, Congress did not include any additional retroactive language within Section 25(a)(4). To have done so would have been superfluous. Section 25(d) governs the date of effectiveness for Section 25 in its entirety, which of course includes Section 25(a)(4). In light of the plain language of Section 25(d) and the express effect that it would have on Section 25(a)(4), Congress chose not to modify Section 25(d). This in itself is evidence of Congress' intent to apply Section 25(a)(4) to contracts entered into prior to enactment of the CFMA. See United States v. Kairys, 782 F.2d 1374, 1382 (7th Cir.) (the fact that the amendment "was placed in a section already governed by a separate provision for retroactivity, a provision of which Congress was presumably aware when passing the amendment . . . ."), cert. denied, 476 U.S. 1153 (1986).

Congressional intent concerning the application of Section 25(a)(4) to transactions entered into prior to enactment of the CFMA is equally clear. As set forth above,

during consideration of the CFMA, there was a chorus of congressional and industry calls sounding the critical need for increased legal certainty. Congress was cognizant of, and particularly sensitive to, the nexus between ensuring the enforceability of OTC derivatives contracts and the fostering of economic growth and stability through proper legal and regulatory policies. Congress responded to the concerns over actions by the CFTC by commissioning the President's Working Group's Report, the conclusions of which were the "groundwork for many of the legal certainty provisions" incorporated in the CFMA. 146 Cong. Rec. H 10416 (Oct. 19, 2000) (statement of Rep. Ewing), LEXIS 146 Cong Rec H 10441. Representative Eliot Engel noted that:

> The President's Working Group on Financial Markets has testified that securing legal certainty for financial derivatives is <u>imperative to reducing risk within America's financial system</u>. This legislation [an earlier version of the CFMA], while a compromise on many points, is not only an important step toward achieving the legal certainty our financial markets need but will foster <u>continued</u> American innovation in the increasingly important realm of derivative financial products.

146 Cong. Rec. H 10411 (Oct. 19, 2000) (statement of Rep. Engel), LEXIS 146 Cong Rec H 10415 (emphasis added). The imperative to enact an enforceability provision "so that the rules of commerce will be clear" was driven by the growth and importance of OTC derivatives activities. 146 Cong. Rec. E 858 (May 25, 2000) (statement of Rep. Stenholm).

The legislative history of the CFMA also reflects Congress' awareness of the size and scope of the OTC derivatives market. <u>See</u> this Memo at 15-16, <u>infra</u>. Congress' knowledge of and consideration of these facts reflects an explicit awareness of the importance of the enforceability of existing privately negotiated derivatives contracts. Given the staggering amount of risk associated with some significant part of these outstanding counter derivatives transactions being attacked as illegal, the House Agriculture Committee underscored its

understanding of "the urgency of giving legal certainty to a $90 trillion swaps market." 146 Cong. Rec. H 10416 (Oct. 19, 2000) (statement of Rep. Combest), LEXIS 146 Cong Rec H 10440. An adequate measure of protection could not be ensured without legislatively addressing previously entered into, as well as future, transactions. Congressman James Leach, then Chairman of the House Committee on Banking and Financial Services, explained the immediacy of congressional concern, as well as the envisioned scope of Section 25(a)(4)'s application, when he stated, "Because of the anachronistic constraints established under the Commodity Exchange Act, legal uncertainty exists for trillions of dollars of existing contractual obligations." 146 Cong. Rec. E 1877 (Oct. 23, 2000) (statement of Rep. Leach), LEXIS Cong Rec E 1877 (emphasis added).

Therefore, it is not reasonable to conclude that Congress wanted to limit the scope of Section 25(a)(4) and to provide legal certainty only for prospective agreements entered into after the CFMA was signed into law in December 2000. Such a conclusion would anomalously have left existing agreements with trillions of dollars in notional value subject to legal challenge by parties seeking to evade their legitimate contractual obligations. In other words, only by applying Section 25(a)(4) to cover derivatives transactions entered into prior to enactment of the CFMA could Congress truly have eliminated "the cloud of legal and regulatory uncertainty that has shadowed these products since their invention." See 146 Cong. Rec. H 10416 (Oct. 19, 2000) (statement of Rep. Toomey), LEXIS 146 Cong Rec H 10447. Similarly, Senator Gramm explained on the Senate Floor that "the bill eliminates the legal uncertainty that today hangs as an ominous cloud over the $60 trillion financial swaps markets." 146 Cong. Rec. S. 11918 (Dec. 15, 2000) (statement of Sen. Gramm), LEXIS 146 Cong Rec S 11926.

POINT II

THE FAILURE TO APPLY SECTION 25(a)(4) TO CLAIMS THAT AROSE PRIOR TO ENACTMENT OF THE CFMA WOULD HAVE A SUBSTANTIAL ADVERSE EFFECT ON THE FINANCIAL MARKETS IN THE UNITED STATES

The question of whether Section 25(a)(4) applies to transactions outstanding as of when the CFMA was enacted is critical to the stability of the derivatives markets in the United States and to the competitive position of the United States and the global financial marketplace. The CFMA, especially Section 25(a)(4), resulted from many years of effort and consideration by Congress and numerous interested parties. Throughout that process, all parties involved agreed that the CEA should not be used as a shield by sophisticated parties that entered into unprofitable transactions to escape from their contractual obligations. Congress thus inserted Section 25(a)(4) in the most logical place in the CEA for it to appear – the provision governing private rights of action. Otherwise, the risks to the financial markets would persist for many years.

The Senate Committee on Agriculture, Nutrition and Forestry recognized the ability of OTC derivatives transactions to transfer risk and thereby to dissipate systemic risk. See S. Rep. No. 106-390 at 1 (Aug. 25, 2000).[4] That Committee also concurred in its report with a statement by Federal Reserve Board Chairman Alan Greenspan that described the development of derivatives as "the most significant event in finance of the past decade." Id. at 2. Congress further noted that: "The notional value of the derivatives market is fast approaching $100 trillion. By comparison, the entire Federal budget is closer to $1.7 trillion." 146 Cong. Rec. H 10411 (Oct. 19, 2000) (statement of Rep. Carolyn Maloney), LEXIS 146 Cong Rec H 10412.

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[4] Specifically, the Committee noted that derivatives have played a significant role in the U.S. economy "due to their innovative nature and risk-transferring attributes . . . . Derivatives enable companies to unbundle and transfer risk to those entities who are willing and able to accept it. By doing so, efficiency is enhanced as firms are able to concentrate on their core business objectives." S. Rep. No.106-390 at 2.

The Working Group's Report observed that: "At year-end 1998, the total estimated notional amount of outstanding OTC derivative contracts was $80 trillion, reflecting an increase of 11 percent from June 1998, according to data from the Bank for International Settlements." See Working Group's Report at 4. The House Banking Committee gave due consideration to that fact, noting the enormous growth in the derivatives markets during the course of the 1990s. See H.R. Rep. No. 106-711, Part 2, at 53. The committee went on to state:

> OTC derivatives have become essential to banks' risk management strategies, their propriety [sic] trading activities, and the services they provide their customers. Large banks have made customized risk management readily available to a wide range of enterprises, providing liquid and creditworthy contracts. At the same time, banks of all sizes in communities across the country have used swaps to insulate themselves against the vicissitudes of interest rate and other economic risks. In sum, banks are central to financial OTC derivatives markets and these markets have become central to a wide range of banking activities.
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> Legal uncertainty raised the prospect that a banking product might be found to be a futures contract, thus subject to commodity futures law and regulation. In the unlikely event that the CFTC or a court determines that a swap is an illegal off-exchange futures contract, systemic difficulties could result. A determination that a swap is a futures contract could jeopardize the value of billions of dollars worth of swaps on the books of banks. Legal uncertainty is a potential impediment to the growth of the swaps business in the United States and poses unwarranted and unnecessary risks on the financial system as a whole.
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> * * *
>
> U.S. Banking Regulators warn that uncertainties and unintended consequences associated with the CEA could potentially turn financial disruptions in the global system into financial disasters.

Id. at 54. As those observations reflect, Congress was very much aware that the financial community could no longer afford to be confronted with any risk, be it retroactive or

prospective, with respect to any challenges to the legitimacy and enforceability of OTC derivatives transactions in the United States financial markets.

Under these circumstances, the three amici strongly believe that the Magistrate Judge's recommendation would reestablish in the very risks and consequences that Congress sought to eliminate. In order to avoid disruption of the financial markets, Section 25(a)(4) must apply equally to OTC derivatives transactions created before December 21, 2000, just as much to those made after that date. As of December 2000, according to the Bank for International Settlements, the notional value of all outstanding derivative transactions was $95.2 trillion.[5] See www.bis.org/publ/r__q5a0112pdf#page=89. The consequence of the Magistrate Judge's recommendation would mean that, for many of those open transactions, a counterparty could attempt to repudiate its contractual obligations. That prospect would reintroduce legal uncertainty and could cause substantial disruption to the financial community. In light of the strong legislative history demonstrating that Congress sought to eradicate completely such a risk, there is no rational, let alone legislative, justification or basis to permit such a risk to reemerge in the financial markets.

Accordingly, in order to continue to safeguard the market for derivatives transactions, both in the United States and globally, it is important that the CFMA be given the application intended by Congress. The objection to the Magistrate Judge's recommendation regarding the application of Section 25(a)(4) must therefore be sustained.

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[5] According to statistics collected by Arthur Andersen on behalf of ISDA, the volume of global OTC interest rate and currency derivatives contracts in 2000 increased by 8.14 percent. The notional volume for those derivatives transactions during the year was approximately $60.3 trillion. See www.isda.org/statistics/2000end.html.

CONCLUSION

For the foregoing reasons, amici curiae The International Swaps and Derivatives Association, Securities Industry Association and The Bond Market Association respectfully submit that the Magistrate Judge's recommendation that Section 25(a)(4) does not apply retroactively should be rejected.

Dated: New York, New York
February 22, 2002

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