

6. Derivative Markets and Their Regulation

Introduction

Risk is inherent in human affairs. Some risks can be managed by pooling individuals into a larger group, as with automobile insurance. Others can be addressed by diversification, as with mutual funds. Still others can be mitigated with stockpiles: in ancient Egypt, granaries were built to store grain to cover periods of drought; and in the United States, a Strategic Petroleum Reserve has been built to counter the risk of supply disruptions. As described in the first section of this report, derivatives have become increasingly important over the past two decades as a means of transferring the financial risks associated with price volatility in commodity markets and, in particular, energy markets.

This chapter recounts the rapid growth of derivative markets following the deregulation of exchange rates, freeing of interest rates, and decontrol of energy prices and describes in some detail how they are traded. The regulatory structure applicable to derivative contracts in the United States is described briefly, including the role of the Commodity Future Trading Commission (CFTC), the Securities and Exchange Commission (SEC), and the Federal Reserve Board (FED) in the regulation of

exchanges, over-the-counter (OTC) markets, and banks that are active in derivative markets. Exemptions of energy commodities and electronic exchanges from CFTC regulation are also discussed.

Development of Derivative Markets

Although derivatives have been used in agricultural markets since the mid-1800s, much of the growth in their use over the past several decades has been in financial markets as a direct response to increased volatility in credit and foreign exchange markets. After the decision was made to allow exchange rates to “float,” they became very volatile. The futures exchanges and OTC markets responded by creating derivative products that could be used to mitigate financial risks related to this volatility. Today the most heavily traded contracts on futures exchanges are on such products as U.S. Treasury Bonds, the S&P 500 stock index, and Eurodollars. Likewise, the most heavily traded products in the OTC markets are contracts based on interest rates and foreign currencies.

Table 13 shows the notional amounts and market values of global outstanding OTC derivative contracts at the

Table 13. Trading Activity in Global Over-the-Counter Markets, 1998 and 2001
(Billion U.S. Dollars)

Risk Category and Instrument	Notional Amounts		Gross Market Value	
	June 1998	December 2001	June 1998	December 2001
Total Notional Value	72,144	111,115	2,579	3,788
Foreign Exchange Contracts	18,719	16,748	799	779
Outright Forwards and Forex Swaps	12,149	10,336	476	374
Currency Swaps	1,947	3,942	208	335
Options	4,623	2,470	115	70
Interest Rate Contracts	42,368	77,513	1,159	2,210
Forward Rate Agreements	5,147	7,737	33	19
Interest Rate Swaps	29,363	58,897	1,018	1,969
Options	7,858	10,879	108	222
Equity-Linked Contracts	1,274	1,881	190	205
Forwards and Swaps	154	320	20	58
Options	1,120	1,561	170	147
Commodity Contracts	452	598	38	75
Gold	193	231	10	20
Other Commodities	259	367	28	55
Forwards and Swaps	153	217	—	—
Options	106	150	—	—
Other	9,331	14,375	393	519

Source: Bank for International Settlements.

end of June 1998 and December 2001.⁹⁰ The global market for OTC derivatives amounted to \$111 trillion in December 2001 up from \$72 trillion in June 1998. The increase represents an average yearly rise of 11.4 percent. Interest rate derivatives accounted for the greatest activity, with \$78 trillion in notional amounts outstanding as of December 2001, followed by foreign exchange markets, with \$17 trillion outstanding. OTC derivatives on physical commodities represented the least active category of contracts, with an outstanding notional value of \$0.6 trillion as of December 2001. Although that amount is small overall in comparison with interest rate and foreign exchange products, the yearly average growth rate of 8 percent since 1998 is comparable.

While trading in OTC derivatives has grown rapidly over the past decade, exchange-based trading in futures contracts, particularly in financial and energy commodities, has also progressed (Figure 15). From 1991 to 2001, the total volume of trading in futures contracts increased by 139 percent, or 9.1 percent per year on average. The share of energy-related products (petroleum, natural gas, coal, electricity, etc.) was 13 percent in 1991 and 12 percent in 2001. The contract volumes for energy-related products over the 10-year time period grew by a total of 115 percent, or 8 percent per year. As the energy industry moves toward a more competitive environment, increasing price volatility of energy commodities can be expected to induce further growth in the demand for energy futures and option contracts.

Trading Environments

Derivative contracts are traded or entered into in several trading environments. Derivatives traded on an exchange are called exchange-traded derivatives. The primary purpose of exchanges is to aggregate a large number of participants in order to build liquidity in a contract. Contracts entered into through private negotiation are typically called off-exchange or OTC derivatives. The primary motive of participants in the OTC markets is to create instruments whose risk-return characteristics closely match the needs of individual customers. In addition, there exist a number of trading systems, such as voice brokering and electronic bulletin boards, that attempt to combine the strengths of the exchange and off-exchange markets, gathering together large numbers of participants but also offering at least some level of customization through individual negotiations. Contracts traded in each market share similar risk-shifting attributes, but the means by which the contracts are negotiated and the information, liquidity, and counterparty risks can be much different. The common threads that tend to run across all markets are the market participants and their functions (see box above).

⁹⁰OTC derivatives, which are not traded on organized exchanges, represent only part of the derivative market.

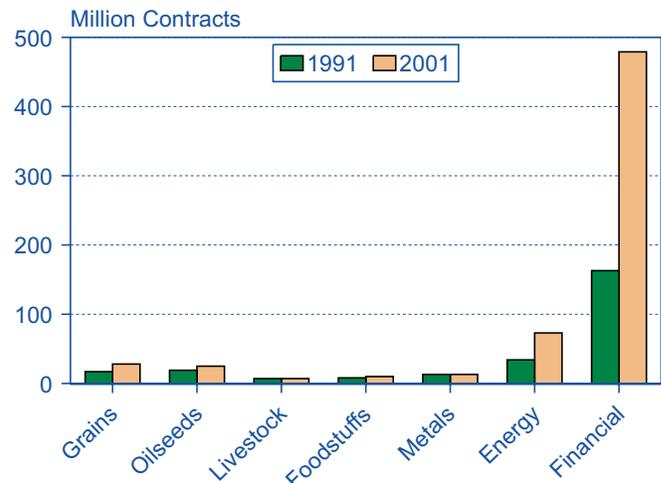
Derivative Market Participants

Hedgers: Enter into derivative contracts to offset similar risks that they hold in an underlying physical market. In so doing, they transfer risk to other market participants, such as speculators or other hedgers. Hedging is the primary social rationale for trading in derivatives.

Speculators: Take unhedged risk positions in order to exploit informational inefficiencies and mispriced instruments or to take advantage of their risk capacity. Speculators are individual traders and companies willing to take on risk in the pursuit of profits.

Arbitrageurs: Take opposite positions in mispriced instruments in order to earn an essentially riskless return. The arbitrage process ensures that prices between related markets stay consistent with one another.

Figure 15. Market Shares of Futures Contracts Traded on U.S. Exchanges by Commodity Type, 1991 and 2001



Source: Commodity Futures Trading Commission.

Each market participant performs a specific role. Speculators play the critical role of taking on the risks that hedgers wish to avoid: without speculators there is no derivatives market. The price of risk is determined by the interaction between how much hedgers are willing to pay to reduce risk and how much speculators require to bear it. Arbitrageurs ensure that the prices of individual risk-bearing instruments are consistent across the various derivative contracts. A well-functioning derivative market requires all three kinds of traders.

Exchange Markets

One of the main features of contracts offered by exchanges is standardization. Standardization ensures

that any one contract is indistinguishable from any other in terms of what, how much, when, and where a commodity is to be delivered. All contracts for a particular commodity and a particular date are the same. Standardization is an important feature in that it allows a trader who, for example, has sold a contract to deliver natural gas at Henry Hub in November to get out of the market easily by buying a contract to deliver natural gas at Henry Hub in November. His net position is zero; he has offset his sell with a buy. If he sells gas for more than he bought it, he profits. Otherwise he loses money.

In addition to offering standard contracts, exchanges offer two other features: a trading platform and a clearing system. The trading platform is the mechanism by which buyers and sellers are brought together and orders are matched. For much of the history of futures and options trading, exchanges have relied on an open outcry system on a designated trading floor or pit at an exchange. During the past decade, however, there has been a move to establish electronic markets for trading in futures and options contracts. Many European and other overseas exchanges have shifted exclusively to electronic trading, although U.S. exchanges still rely primarily on open outcry conducted on the floor of an exchange.

The primary difference between open outcry and electronic trading is the method by which trades are matched. In open outcry, matching relies on the ability of traders in a pit to locate other traders in the pit who have an opposite trading interest. As the name implies, traders cry out their bids and offers in the hope of finding a counterparty. In electronic trading, a computer algorithm takes the place of traders in monitoring bids and offers and finding traders on the other side of the market. Usually the computer screen will list the bids and offers being quoted by traders. Traders may then submit orders in an attempt to “hit” the quotes. When an order that matches a bid or offer enters the computer, the computer algorithm will automatically match the orders, send the match to the clearinghouse for clearing and update the bids and offers displayed on the screen.

Clearing is the procedure by which the clearinghouse becomes the buyer to each seller and the seller to each buyer of every futures and options contract traded on the exchange. The clearinghouse typically is an adjunct to, or division of, a commodity exchange. The mechanics of clearing a trade are straightforward. Once a trade has occurred on the exchange floor or electronic trading system, the information from the trades is sent to the clearinghouse for confirmation. The clearinghouse checks that the information provided by the two parties matches exactly. If it does, the clearinghouse takes the

opposite side of each counterparty that entered into the trade on the exchange.

The main purpose of a clearinghouse is to take the other side of each contract, allowing contracts to be fungible and making it easy for parties to enter into and exit contracts. Because the clearinghouse ultimately ends up on the other side of every contract, a counterparty does not need to be concerned with whom he trades against on the floor of the exchange or whether that person exits his position before the contract expires. If contracts were not cleared, counterparties would need to go back to the original counterparty to negotiate an early termination of the contract or to seek permission to substitute a different counterparty to take on the obligations of the contract. The clearing process eliminates those concerns, allowing exchange customers to enter and exit the market freely.

In the process of making contracts fungible, clearinghouses assure the financial integrity of the contracts. That is, the clearinghouse establishes a guarantee of performance on the contracts. This is typically accomplished through five levels of control that come into play before transactions are ever entered into, while contracts are being held and after problems may arise:

- The first level, control of the credit risk faced by the clearinghouse, is accomplished by admitting only creditworthy counterparties to membership in the clearinghouse.⁹¹ Most clearinghouses do this by establishing minimum financial requirements and standards that its members must meet on an ongoing basis.
- As a second level of control, clearinghouses may impose position limits on members or its members’ customers to limit the potential losses to which a member may be exposed.
- The third level of control is to establish a “margin system” to cover the risk of positions that have been entered into. A margin is essentially a performance bond designed to cover potential short-term losses on futures and options positions.
- The fourth means of protecting contracts is to establish default procedures in the event that a clearing member does default. While these procedures may differ from one clearinghouse to another, they typically involve an attempt to isolate the house accounts of the offending clearing member while transferring the accounts of its non-defaulting customers to other clearing members.
- The fifth level of protection is to establish supplemental resources to cover situations in which a

⁹¹While customers of the exchange are exposed to the credit risk of the clearinghouse, the clearinghouse is exposed to the individual credit risks of the futures commission merchants (FCMs) that are members of the clearinghouse and, ultimately, to the customers of those FCMs.

margin is insufficient to cover losses. This may take the form of outside guarantees, insurance, excess reserve funds, or collateral pools.

Over-the-Counter Markets

Over-the-counter is not a well-defined term. In fact, it is commonly used simply to describe trading activity that does not take place on an exchange, whether that exchange is a futures, options, or stock exchange. For example, in a 1997 report of the U.S. General Accounting Office, OTC derivatives were described as contracts that “are entered into between counterparties, also called principals, outside centralized trading facilities such as futures exchanges.”⁹² The report noted that, in OTC markets, counterparties typically negotiate contract terms such as the price, maturity, and size of the contract in order to customize the contract to meet their economic needs. Moreover, because OTC contracts are entered into on a principal-to-principal basis, each counterparty is exposed to the credit risk of the opposite party.

Although OTC transactions predate the trading of futures contracts, the interest in modern OTC derivatives trading had its beginning in the 1980s, when parties interested in entering into derivative contracts began to explore alternatives to the exchange. Exchange-traded contracts offer high liquidity and low credit risk, but typically they are standardized and inflexible, meaning that users often face large basis risk when using the contracts to hedge.⁹³ By being able to negotiate contract terms, users can reduce basis risk by assuring that the terms of derivative contracts more closely match the characteristics of their physical market positions; however, the advantage of customization generally comes at the expense of liquidity and credit assurances.

Technically, OTC derivatives may be entered into between any two counterparties. In practice, however, the market has come to be structured as a dealer market. In such a market, the end users of derivatives tend to seek out companies (i.e., derivative dealers) that create customized contracts to fit their needs. The dealers then offset the risk of the contracts by entering into exchange-traded futures and option contracts or other OTC derivative contracts that have an opposite risk profile.

The dealer market tends to be dominated by large investment banks and some commercial banks,

although as the market has matured, specialized companies have moved into niches where they may have an informational or operational advantage over the banks. This has been particularly true in the energy and power markets where firms such as American Energy Power, Reliant Energy, Duke Energy, and the large petroleum companies have become significant players in the markets. As a result, the commodity derivative dealer affiliates of the large investment banks have become less dominant, although they continue to be important players. For example, the recently established IntercontinentalExchange, which primarily offers OTC energy contracts, is a joint venture of BP Amoco, Deutsche Bank AG, The Goldman Sachs Group, Inc., Morgan Stanley Dean Witter, Royal Dutch/Shell Group, SG Investment Banking, and the Totalfina Group.

Because OTC derivatives and exchange-traded futures serve similar economic functions, they can be used as substitutes for each other and thus may compete in the marketplace. They are not perfect substitutes, however, because of potential differences in their contract terms, transaction costs, regulations, and other factors. OTC derivatives and exchange-traded futures can also complement each other. For example, swaps dealers use exchange-traded futures to hedge the residual risk from unmatched positions in their swaps portfolios. Similarly, food processors, grain elevators, and other commercial firms use exchange-traded futures to hedge their forward positions.

Regulation of Exchange-Traded Derivatives

The regulation of derivative trading in the United States depends on a variety of circumstances, including whether trading is conducted on an exchange and whether the trader is a bank, an insurance company, or another regulated entity. Regulation of the futures and options markets is accomplished jointly through self-regulation by the exchanges and oversight by the Federal Government through the Commodity Futures Trading Commission (CFTC). In the legislation establishing the CFTC, Congress recognized that futures markets serve a national interest.⁹⁴ Congress sought to assure orderly futures markets, operating fairly, with prices free of distortion.

⁹²U.S. General Accounting Office, *The Commodity Exchange Act: Legal and Regulatory Issues Remain*, GAO/GGD-97-50 (Washington, DC, April 1997).

⁹³Basis risk describes the lack of correlation that may exist between the price of a derivative contract and the price of the commodity that is being hedged. To the extent that these prices move independently, the hedger faces a risk that the change in the value of the physical position may not be entirely offset by the change in the value of the derivative position. Thus, the hedge may not be a perfect one.

⁹⁴Section 3 of the Commodity Exchange Act, 7 U.S.C. Section 5.

The CFTC oversees the enforcement of exchange rules and conducts its own surveillance of trading in futures and related cash markets as part of its mission to prevent market abuse and to enhance market operations. The Commission oversees the regulations and rules of the futures exchanges and requires exchanges to enforce them. The CFTC also relies on its economists and trading experts to monitor contracts and trading in the public interest, to assure that markets provide a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair, and financially secure trading facilities. Finally, the CFTC offers a reparations procedure for customers of CFTC registrants to file grievances.

In addition to regulation by the Federal Government, futures trading is overseen by the National Futures Association (NFA), a “registered futures association” under the Commodity Exchange Act (CEA) that has been authorized by the Commission to register all categories of persons and firms dealing with customers. Before registering a new person or firm, the NFA conducts a thorough background check of the applicant to determine whether they should be precluded from conducting commodity business.

While the CFTC is responsible for the oversight of the U.S. futures and options exchanges, the exchanges themselves have broad self-regulatory responsibilities. Commodity exchanges complement Federal regulation with rules and regulations of their own for the conduct of their markets—rules covering clearance of trades, trade orders and records, position limits, price limits, disciplinary actions, floor trading practices, and standards of business conduct. A new or amended exchange rule must be reported to the CFTC, which may also direct an exchange to change its rules and practices. The CFTC regularly audits the compliance program of each exchange.

Regulation of OTC Derivatives

The overall OTC derivatives “marketplace” encompasses a wide variety of types of transactions and customized products, which generally lack the unifying characteristics of conventional markets. The OTC market exists primarily to meet the needs of customers who are interested in particular commodities—at particular locations and times—that are not available on exchanges. The variety of OTC contracts reflects the variety of individual situations, and unlike the market for exchange contracts the OTC market tends to change quickly.

The OTC marketplace includes, among other types of products, transactions in securities such as OTC options on individual equities and stock indexes; transactions in hybrids such as oil-indexed notes; swaps; and transactions in certain specialized “forward” markets such as the interbank market in foreign currency and the Brent oil market. In addition, the Commodity Futures Modernization Act of 2000 (P.L. 106-554, 114 Stat. 2763) established a number of exemptions and exclusions for qualifying OTC transactions.⁹⁵ These exclusions and exemptions apply to a variety of transactions and contracts involving various counterparties, commodities, and trading arrangements.

Multiple types and levels of regulation, depending on the product and on how transactions are settled, complicate the regulatory landscape for OTC derivatives. Further complexity results from the significant use of OTC derivatives by entities also subject to one or more regulatory regimes, either as intermediaries (e.g., commercial banks and investment banks) or as end users (e.g., pension funds and investment companies). In addition, because OTC derivative transactions grew out of the unbundling of price differentials from commercial transactions, many derivative transactions are conducted directly between unregulated counterparties or corporate end users. Such end-user activity may be in the nature of commercial transactions and, as such, qualitatively different from intermediation, which could involve extensions or guarantees of credit or custodianship of assets or could concentrate risk. The level of regulatory interest in commercial transactions is clearly different from that which would be applied to intermediated transactions.

In addition to transactions in the OTC markets that fall outside CFTC or SEC jurisdiction, there are certain transactions that may fall within these agencies’ jurisdiction but are regulated differently from exchanged-traded products. The exchange regulatory model is a basic component of both the CFTC and SEC regulatory systems; however, neither is confined to transactions occurring on centralized exchange markets. Both the CFTC and SEC regulatory frameworks currently contemplate less comprehensive regulation of certain essentially private transactions with accredited parties than for exchange trading or public securities offerings. These categories of reduced regulatory requirements are directly relevant to the OTC derivatives market.

Under the CEA, centralized trading of futures contracts and commodity options on CFTC-approved exchanges is the exclusive form of permissible trading, absent a specific exemption or exclusion. In late 1992, however, Congress granted this authority in the Futures Trading

⁹⁵See Commodity Exchange Act, Sections 2d—Excluded Derivative Transactions; 2e—Excluded Electronic Trading Facilities; 2f—Exclusion for Qualifying Hybrid Instruments; 2g—Excluded Swap Transactions; and 2h—Legal Certainty for Certain Transactions in Exempt Commodities (7 U.S.C. 2d, 2e, 2f, 2g and 2h).

Practices Act of 1992 (FTPA).⁹⁶ Using this authority, the CFTC acted in 1993 to grant several exemptions for OTC derivative contracts. The first exemptions were granted for swaps and other OTC derivative contracts and for hybrid instruments.⁹⁷ They were soon followed by a CFTC order exempting certain energy contracts from regulation under the CEA, including the antifraud provision of the CEA.⁹⁸ The purpose of the order was to improve the legal certainty of energy contracts and reduce the risk that physical markets would be disrupted. While the swaps and hybrid instrument exemptions applied to all commodities, the order for energy contracts extended only to contracts for the purchase and sale of crude oil, natural gas, natural gas liquids, or other energy products derived from crude oil, natural gas, natural gas liquids, and used primarily as an energy source. Moreover, the order applied only to energy contracts entered into between principals.

While the FTPA and the exemptions granted under it by the CFTC allowed the OTC markets in derivatives to continue to develop, it did not specifically address whether or not any particular type of transaction, such as a swap agreement, is a futures or an option. As a result of this omission and the continuing evolution of the OTC markets, concerns about legal uncertainty persisted. Thus, in 1998 Congress indicated that the President's Working Group on Financial Markets (Working Group)⁹⁹ should work to develop policy with respect to OTC derivative instruments,¹⁰⁰ and the Chairmen of the Senate and House Agricultural Committees requested that the Working Group conduct a study of OTC derivatives markets and provide legislative recommendations to Congress.¹⁰¹ In general, the Working Group recommended that OTC derivatives traded between sophisticated counterparties should be excluded from the CEA. Similarly, the group recommended that electronic trading systems for derivatives on financial commodities should also be excluded from CFTC regulation.

On December 21, 2000, Congress passed the Commodity Futures Modernization Act of 2000 (CFMA),¹⁰² incorporating many of the recommendations contained in the Working Group report. With respect to the energy and power markets, the relevant exclusions and exemptions contained in the CFMA are the exclusion for hybrid instruments, the exclusion for swap transactions, the exemption for transactions in exempt commodities, and the exemption for commercial markets. Each of these exemptions and exclusions can be relied on by issuers of the contracts, depending on the nature of the counterparties and the means by which the contracts are entered into. Table 14 summarizes the various exemptions and exclusions available to energy- and power-related contracts.

For OTC derivatives exempt or excluded from CFTC regulation, the application of a regulatory scheme typically is based on the party that is offering or entering into the contract being a registered entity. The contract or transaction itself, however, is typically not regulated.¹⁰³ Similarly, the SEC has the authority only to regulate the activities of broker-dealers.¹⁰⁴ These firms are required to register with the SEC and comply with its requirements for regulatory reporting, minimum capital, and examination; however, U.S. securities laws do not apply to a broker-dealer's entire organizational structure, which may also include a holding company and other affiliates. Thus, because the SEC's jurisdiction extends only to securities, and because it does not regulate affiliates of broker-dealers whose activities do not involve securities, the SEC has only limited authority. In essence, the jurisdiction of the SEC extends only to the activity of broker-dealers that engage in both securities and derivatives activities.

Unlike the authority of the CFTC and SEC to oversee activities related to futures and securities, respectively, Federal banking regulators oversee all bank activities,

⁹⁶Section 4(c) of the Commodity Exchange Act, 7 U.S.C. § 6(c), added by the Futures Trading Practices Act of 1992, grants the Commission broad authority to exempt any agreement, contract, or transaction (or class thereof) from any of the requirements of the Act except Section 2(a)(1)(B), 7 U.S.C. § 2a, based upon, among other things, a determination that such exemption would be consistent with the public interest.

⁹⁷"Exemption for Certain Swap Agreements," 58 FR 5587 (January 22, 1993), and "Regulation of Hybrid Instruments," 58 FR 5580 (January 22, 1993).

⁹⁸"Exemption for Certain Contracts Involving Energy Products," 58 FR 21286 (April 20, 1993) It should be noted that the CFTC Commissioner, Sheila Bair, dissented from the majority, voting against the order on the basis of its failure to retain the general antifraud provisions of the CEA. See 58 FR at 21295 (April 20, 1993).

⁹⁹The Working Group is comprised of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission, and the Chairman of the Commodity Futures Trading Commission.

¹⁰⁰H.R. Rep. No. 825, 105th Congress, 2nd Session, 991-992 (1998).

¹⁰¹Letter from the Honorable Richard G. Lugar, Chairman, Senate Committee on Agriculture, Nutrition, and Forestry, and the Honorable Robert Smith, Chairman, House Committee on Agriculture, to the Honorable Robert Rubin, Secretary of the Treasury (September 30, 1998).

¹⁰²P.L. 106-554, 114 Stat. 2763.

¹⁰³The exception is a hybrid instrument, which would be regulated as a security or a bank product.

¹⁰⁴Broker-dealers are firms that buy and sell securities for their own accounts and as agents for their customers.

including derivatives activities. A primary purpose of Federal banking regulation is to ensure the safety and soundness of individual banks and the U.S. financial system. Bank regulators, therefore, are authorized to regulate affiliates of banks or bank holding companies, regardless of the activities in which they are engaged. Bank regulators rely on three primary means to oversee bank activities: reviewing required reports; requiring adherence to minimum capital standards; and conducting periodic examinations to verify compliance with reporting, capital, and other regulatory requirements. The banking regulators, however, do not regulate the specific transactions or maintain oversight of OTC derivatives as a class of instruments.

Finally, derivatives may also fall under the jurisdiction of a State insurance regulator. Like banking regulators, State insurance regulators generally regulate the overall activities of their regulatees, including the types of transactions or trading activities in which they may engage.

Thus, a State regulator may indirectly regulate derivative trading activity by allowing or not allowing insurance companies to engage in such activity.

In summary, OTC derivatives may fall into one of four general regulatory jurisdictions—CFTC, SEC, a banking regulator, or an insurance regulator—or none at all. For transactions falling within the purview of the CEA, the transactions themselves as well as those offering the contracts fall under the regulatory scheme of the CFTC. If a contract is either exempt from or excluded from the CEA but is either a security product or offered or entered into by an SEC, banking registrant, or insurance company, the contract would be regulated under the regulatory authority of the SEC or the relevant banking or insurance regulator. If the contract does not fall within the regulatory authority of the SEC or banking or insurance regulator, it would be subject only to general commercial laws.

Table 14. CEA and CFTC Exemptions and Exclusions for OTC Derivative Transactions

Exemption or Exclusion	Type of Exemption or Exclusion	Commodity	Trader	Conditions	Retained Rules
Forward Contract Exclusion: 1a(19) of CEA	Statutory exclusion	All	No restriction	Any sale of any cash commodity for deferred shipment or delivery	None
Exclusion for Hybrid Instruments: 2(f) of CEA	Statutory exclusion	All	No restriction	Hybrid instruments that are predominantly securities as defined in the exclusion	None
Exclusion for Swap Transactions: 2(g) or CEA	Statutory exclusion	All non-agricultural	Eligible contract participants ^a	Transactions subject to individual negotiation and not executed on a trading facility	None
Transactions in Exempt Commodities: 2(h)(1)	Statutory exemption	Exempt commodities ^b	Eligible contract participants	Transactions not executed on a trading facility ^c	Anti-fraud and anti-manipulation
Exempt Commercial Markets: 2(h)(3)	Statutory exemption	Exempt commodities	Eligible commercial entities	Transactions executed on an electronic trading facility ^d	Anti-fraud and anti-manipulation; Rules related to transaction information dissemination as prescribed by the Commission if found to be a price discovery market
Trade Option Exemption: CFTC Part 32.4(a)	Regulatory exemption	All non-enumerated agricultural commodities ^e	Commercial entities ^f	One party must be a commercial entity using the option for purposes related to its business	Anti-fraud
Hybrid Instrument Exemption: CFTC Part 34	Regulatory exemption	All	No restriction	Hybrid must be predominantly a security or banking product as measured by CFTC prescribed predominance test	None (Securities or bank products must be subject to regulation by the SEC or a banking regulator)
Swap Exemption: CFTC Part 35	Regulatory exemption	All	Eligible swap participants ^g	Not part of a fungible class of agreements that are standardized; creditworthiness is a material consideration; not traded on a multilateral transaction execution facility	Anti-fraud and anti-manipulation
Energy Order: 58 FR 21286 (April 20, 1993)	Regulatory exemption	Crude oil, natural gas, natural gas liquids and their derivative products	Commercial participants in the energy markets	Transactions between principals and subject to individual negotiation; no unilateral right of offset	None

^aDefined in §1a(12) of the CEA.

^bDefined in §1a(14) of the CEA.

^cDefined in §1a(33) of the CEA.

^dDefined in §1a(10) of the CEA.

^eThe “enumerated commodities” are listed in §1a(4) of the CEA and generally include the major domestically produced field crops and livestock.

^fPart 32.4 of the CFTC’s regulations limits users of trade options to producers, processors, or commercial users of, or merchants handling a commodity, or byproducts of such commodity.

^gDefined in §35.1(b)(2) of the CFTC’s regulations.