

III. Discussion

The Chicago Mercantile Exchange ("CME") has proposed that the Commission amend Rule 3a12-8 to include the sovereign debt of the Proposed Countries.⁵ The CME intends to develop a futures contract market in Brady bonds issued by the Proposed Countries.⁶ Brady bonds are issued pursuant to the Brady plan which allows developing countries to restructure their commercial bank debt by issuing long-term dollar denominated bonds.⁷ The Commission understands that Brady bonds issued by the Proposed Countries are currently traded primarily in the over-the-counter market in the United States.

Under the proposed amendment, the existing conditions set forth in the Rule (*i.e.*, that the underlying securities not be registered in the United States,⁸ the futures contracts require delivery

outside the United States,⁹ and the contracts be traded on a board of trade) would continue to apply.

In determining whether to amend the Rule to add new countries, the Commission has considered whether there is an active and liquid secondary trading market in the particular sovereign debt. There appears to be an active and liquid market in the debt instruments of the Proposed Countries. According to the CME, as of December 31, 1993, the total public and publicly guaranteed debt¹⁰ of Brazil, Argentina, and Venezuela was approximately US\$86 billion, US\$55 billion, and US\$74 billion, respectively.¹¹ Moreover, the cash market for Brady bonds issued by the Proposed Countries evidences relatively active trading. Based on data provided by the CME, the total 1994 trading volume in the Brady bonds of Brazil, Argentina, and Venezuela was approximately US\$371 billion, US\$360 billion, and US\$320 billion, respectively.¹²

In light of the above data, the Commission believes preliminarily that the debt obligations of the Proposed Countries should be subject to the same regulatory treatment under the Rule as the debt obligations of the Designated Foreign Governments. Moreover, the trading of futures on the sovereign debt of Brazil, Argentina, and Venezuela should provide U.S. investors with a vehicle for hedging the risks involved in the trading of the underlying sovereign debt of the Proposed Countries.

In addition, the Commission preliminarily believes that the proposed amendment offers potential benefits for U.S. investors. If adopted, the proposed amendment would allow U.S. boards of trade to offer in the United States, and U.S. investors to trade, a greater range

of futures contracts on foreign government debt obligations. The Commission does not anticipate that the proposed amendment would result in any direct cost for U.S. investors or others. The proposed amendment would impose no recordkeeping or compliance burdens, and merely would provide a limited purpose exemption under the federal securities laws. The restrictions imposed under the proposed amendment are identical to the restrictions currently imposed under the terms of the Rule and are designed to protect U.S. investors.

Section 23(a)(2) of the Exchange Act requires the Commission in amending rules to consider potential impact on competition. Because the proposal is intended to expand the range of financial products available in the United States, the Commission preliminarily believes that the proposed amendment to the Rule will not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

IV. Request for Comments

The Commission seeks comments on the desirability of designating the debt securities of the Proposed Countries as exempted securities under Rule 3a12-8. Comments should address whether the trading or other characteristics of the Proposed Countries' debt warrant an exemption for purposes of futures trading. Commentators may wish to discuss whether there are any legal or policy reasons for distinguishing between the Proposed Countries and the Designated Foreign Governments for purposes of the Rule. The Commission also solicits comments on the costs and benefits of the proposed amendment to Rule 3a12-8. Specifically, the Commission requests commentators to address whether the proposed amendment would generate the anticipated benefits, or impose any costs on U.S. investors or others. Finally, the Commission seeks comment on the general application and operation of the Rule given the increased globalization of the securities markets since the Rule was adopted.

V. Regulatory Flexibility Act Certification

Pursuant to Section 605(b) of the Regulatory Flexibility Act, 5 U.S.C. § 605(b), the Chairman of the Commission has certified that the amendment proposed herein would not, if adopted, have a significant economic impact on a substantial number of small entities. This certification, including the reasons therefor, is attached to this release as Appendix A.

"Federal Republic of Germany," and (3) replace all references to the informal names of the countries listed in the Rule with references to their official names. See Securities Exchange Act Release No. 30166 (January 6, 1992), 57 FR 1375 (January 14, 1992). In 1994, the Rule was amended to include debt securities issued by the Kingdom of Spain. See Securities Exchange Act Release No. 34908 (October 27, 1994), 59 FR 54812 (November 2, 1994). Finally, the Rule was amended to include the debt securities of Mexico. See Securities Exchange Act Release No. 36530 (November 30, 1995), 60 FR 62323 (December 6, 1995) ("Mexico Adopting Release").

⁵ See Letter from William J. Brodsky, President and Chief Executive Officer, CME, to Arthur Levitt, Jr., Chairman, Commission, dated November 10, 1995 ("CME petition").

⁶ The marketing and trading of foreign futures contracts is subject to regulation by the CFTC. In particular, Section 4b of the CEA authorizes the CFTC to regulate the offer and sale of foreign futures contracts to U.S. residents, and Rule 9 (17 CFR 30.9), promulgated under Section 2(a)(1)(A) of the CEA, is intended to prohibit fraud in connection with the offer and sale of futures contracts executed on foreign exchanges. Additional rules promulgated under 2(a)(1)(A) of the CEA govern the domestic offer and sale of futures and options contracts traded on foreign boards of trade. These rules require, among other things, that the domestic offer and sale of foreign futures be effected through the CFTC registrants or through entities subject to a foreign regulatory framework comparable to that governing domestic futures trading. See 17 CFR 30.3, 30.4, and 30.5 (1991).

⁷ There are several types of Brady bonds, but "Par Bradys" and "Discount Bradys" represent the great majority of issues in the Brady bond market. In general, both Par Bradys and Discount Bradys are secured as to principal at maturity by U.S. Treasury zero-coupon bonds. Additionally, usually 12 to 18 months of interest payments are also secured in the form of a cash collateral account, which is maintained to pay interest in the event that the sovereign debtor misses an interest payment.

⁸ The Commission notes that while no Brady bonds of Proposed Countries have been registered in the United States, certain sovereign debt issues of Argentina and Venezuela have been so registered. The trading of futures on U.S.-registered debt securities of Argentina and Venezuela would not be exempted under Rule 3a12-8 from the CEA's general prohibition on futures overlying individual securities.

⁹ The CME's proposed futures contracts will be cash-settled (*i.e.*, settlement of the futures contracts will not entail delivery of the underlying securities). The Commission has recognized that a cash-settled futures contract is consistent with the requirement of the Rule that delivery must be made outside the United States. See Securities Exchange Act Release No. 25072 (October 29, 1987), 52 FR 42277 (November 4, 1987).

¹⁰ Public debt is an external obligation of a public debtor, including the national government, a political subdivision (or any agency of either) and autonomous public bodies. Publicly guaranteed debt is an external obligation of a private debtor that is guaranteed for repayment by a public entity.

¹¹ See Letter from Carl A. Royal, Senior Vice President and Special Counsel, CME, to James T. McHale, Attorney, OMS, Division, Commission, dated November 30, 1995 (citing the World Bank's 1995 World Debt Tables as the source for this information) ("November 30 letter").

¹² See November 30 letter, *supra* note 11. As mentioned earlier, the Commission recently amended the Rule to include the debt securities of Mexico. The total 1994 trading volume in Mexican Brady bonds was approximately US\$282.3 billion. See Mexico Adopting Release, *supra* note 4.