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PREFACE

Derivatives Regulation represents a comprehensive update and expansion of what was known for three editions over 20 + years as *Commodities Regulation*. As we noted in the preface to the third edition of *Commodities Regulation* (1998), the subject matter of the treatise “is now more commonly referred to as ‘derivatives’ in order to capture not only the futures contracts, options, and other structured instruments offered by organized markets but also a wide variety of exotic and hybrid financial products that are vended privately by banks and investment houses.” The entire area has experienced exponential growth, with no signs of exhaustion, while the applicable laws and regulations have undergone an upheaval of their own.

Derivatives Regulation has been developed far from the beaches of southeast Puerto Rico where the first edition of *Commodities Regulation* was created. It is the product of diligent attention to detail and many hours of research and writing, and all of this in addition to the authors’ respective “day jobs” as a practitioner and a professor. The latter occupations, on the other hand, have made it easier to incorporate in this treatise much practical knowledge and experience that aids the reader in formulating quick, realistic, and thoughtful advice.

Derivatives Regulation also discusses comprehensively the outcome of what was described in the preface to the third edition of *Commodities Regulation* as “potentially radical legislation” which was subsequently enacted in year 2000 by the Congress and that has changed both the character and the charter of the Commodity Futures Trading Commission. Moreover, *Derivatives Regulation* explains the interaction between the CFTC and the Securities and Exchange Commission in their unique relationship of co-regulating certain futures contracts involving securities, as well as providing useful background on relevant aspects of the regulation of securities generally.

The past decade, in particular, has witnessed explosive growth in both the exchange-traded and privately-offered derivatives area. Trading is based, in each case, on assets valued in the trillions of dollars. Irrespective of which “camp” one is in, however, there are laws and regulations that impact both sectors. As the title *Derivatives Regulation* indicates, this treatise comprehensively covers regulatory issues for derivatives in general. It is shown, for example, that while over-the-counter derivatives like swap transactions and structured securities may be less pervasively regulated than the exchange-traded products, there are plenty of opportunities to run afoul of laws and rules that tangentially lurk along the path of doing this business.

All derivatives, whether traded on-exchange or sold through private negotiations, have much in common. Principally, they seek to emulate an actual event or

transaction, to “synthesize” it, so that the economic effects can be generated but without having to conduct the physical business itself. As such, they provide opportunities not only to gain financial exposure to matters without actually participating in them but also to neutralize or “hedge against” real business or financial risks through the creation of synthetic transactions creating opposite risks.

The Commodity Exchange Act and the regulations of the CFTC, although primarily focused on exchange-listed futures contracts and commodity-based options, are perhaps the greatest concerns to private vendors of other derivatives as well. The CFTC has adopted rules, orders, exemptions, policy statements, and statutory interpretations that *directly affect* swap dealers, issuers of exotic securities, and designers of structured financial products. The third edition recognizes and addresses that reality.

Of course, the traditional terrain of commodities regulation has changed as well. This treatise picks up where *Commodities Regulation* began and seeks to bring the reader totally up-to-date, discussing the latest regulations and initiatives affecting the traditional futures and commodity options business. Developments in Congress, in the courts (including the U.S. Supreme Court), and at the CFTC have carved out new obstacles as well as new forms of relief for market participants and professionals.

On December 21, 2000, the President signed into law the most dramatic changes in futures market regulation since that phenomenon began 78 years earlier. The Commodity Futures Modernization Act (CFMA) tore down the barriers to trading that resulted from the contract market monopoly that had been so firmly embedded in commodities law. It codified derivative regulation and clarified the respective roles of the CFTC and the SEC. The new Act called for co-regulation of certain derivatives by these two agencies. In addition, the new Act eliminated the prohibition on individual stock futures that had been a mainstay of the former regulatory environment. The CFMA also validated the role of derivatives as synthetic events by defining a commodity to include contingencies beyond the control of the contracting parties.

Finally, the authors have felt, at times, like painters commissioned to capture on canvas an ever-changing ocean wave. So much is occurring in the field of commodities law, securities law, and derivatives regulation, on even a daily basis, that it is simply impossible to be totally current. Events pay no heed to publishers’ production schedules, or to the fact that a point is reached when further corrections simply cannot be made. Where change appears imminent, we have alerted the reader to that fact, but our predictive powers are limited. Future supplementation will go far toward maintaining the currency of this treatise. But, for the present, the reader is cautioned to use this treatise in conjunction with the latest sources that will reveal the changes in the law that will no doubt have occurred by publication date.

Philip McBride Johnson
Thomas Lee Hazen

May 2004

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