however, that the list of qualified organizations provided by a Commission registrant that is a floor broker need not include a registered futures association unless a registered futures association has been authorized to act as a decision-maker in such matters.

(ii) The customer shall, within forty-five days after receipt of such list, notify the opposing party of the organization selected. A customer's failure to provide such notice shall give the opposing party the right to select an organization from the list.

(6) *Fees.* The agreement must acknowledge that the Commission registrant will pay any incremental fees that may be assessed by a qualified forum for provision of a mixed panel, unless the arbitrators in a particular proceeding determine that the customer has acted in bad faith in initiating or conducting that proceeding.

(7) *Cautionary Language.* The agreement must include the following language printed in large boldface type:

Three Forums Exist for the Resolution of Commodity Disputes: Civil Court litigation, reparations at the Commodity Futures Trading Commission (CFTC) and arbitration conducted by a self-regulatory or other private organization.

The CFTC recognizes that the opportunity to settle disputes by arbitration may in some cases provide many benefits to customers, including the ability to obtain an expeditious and final resolution of disputes without incurring substantial costs. The CFTC requires, however, that each customer individually examine the relative merits of arbitration and that your consent to this arbitration agreement be voluntary.

By signing this agreement, you: (1) May be waiving your right to sue in a court of law; and (2) are agreeing to be bound by arbitration of any claims or counterclaims which you or [name] may submit to arbitration under this agreement. You are not, however, waiving your right to elect instead to petition the CFTC to institute reparations proceedings under Section 14 of the Commodity Exchange Act with respect to any dispute that may be arbitrated pursuant to this agreement. In the event a dispute arises, you will be notified if [name] intends to submit the dispute to arbitration. If you believe a violation of the Commodity Exchange Act is involved and if you prefer to request a section 14 ''Reparations'' proceeding before the CFTC, you will have 45 days from the date of such notice in which to make that election.

You need not sign this agreement to open or maintain an account with [name]. *See* 17 CFR 166.5.

(d) *Enforceability.* A dispute settlement procedure may require parties utilizing such procedure to agree, under applicable state law, submission agreement or otherwise, to be bound by an award rendered in the procedure, provided that the agreement to submit the claim or grievance to the procedure was made in accordance with paragraph (c) of this section or that the agreement to submit the claim or grievance was made after the claim or grievance arose. Any award so rendered shall be enforceable in accordance with applicable law.

(e) *Time limits for submission of claims.* The dispute settlement procedure established by a contract market, recognized futures exchange or derivatives transaction facility shall not include any unreasonably short limitation period foreclosing submission of customers' claims or grievances or counterclaims.

(f) *Counterclaims.* A procedure established by a contract market, recognized futures exchange, or derivatives transaction facility under the Act for the settlement of customers' claims or grievances against a member or employee thereof may permit the submission of a counterclaim in the procedure by a person against whom a claim or grievance is brought. The contract market, recognized futures exchange, or derivatives transaction facility may permit such a counterclaim where the counterclaim arises out of the transaction or occurrence that is the subject of the customer's claim or grievance and does not require for adjudication the presence of essential witnesses, parties, or third persons over whom the contract market, recognized futures exchange, or derivatives transaction facility does not have jurisdiction. Other counterclaims arising out of a transaction subject to the Act and rules promulgated thereunder for which the customer utilizes the services of the registrant may be permissible where the customer and the registrant have agreed in advance to require that all such submissions be included in the proceeding, and if the aggregate monetary value of the counterclaim is capable of calculation.

(g) *Institutional customers.* (1) A person who is an ''institutional customer'' as defined in § 1.3(g) of this chapter may negotiate any term of an agreement or understanding with a Commission registrant in which the institutional customer agrees, prior to the time a claim or grievance arises, to submit such claim or grievance to any settlement procedure, except that signing the agreement must not be made a condition for the institutional customer to use the services offered by the registrant.

(2) If the agreement is contained as a clause or clauses of a broader agreement, the institutional customer must separately endorse the clause or clauses containing the agreement; *Provided, however,* a futures commission merchant or introducing broker may obtain such endorsement as provided in § 1.55(d) of this chapter.

Issued in Washington, D.C. on November 21, 2000 by the Commission.

Jean A. Webb,

Secretary of the Commission.

[FR Doc. 00–30268 Filed 12–12–00; 8:45 am]

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COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 39

RIN 3038–AB57

A New Regulatory Framework for Clearing Organizations

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rulemaking.

SUMMARY: The Commodity Futures Trading Commission (Commission or CFTC) is promulgating a new regulatory framework to apply to clearing organizations. These regulations for clearing organizations are part of an initiative that would also establish a new regulatory framework for multilateral transaction execution facilities (MTEF) and market intermediaries. The final new framework in its entirety is simultaneously announced today in companion releases. The new framework, including these regulations are centered on broad, flexible, core principles and are designed to ''promote innovation, maintain U.S. competitiveness, and at the same time reduce systemic risk and protect customers.'' The Commission has fashioned these regulations so that it can fairly and efficiently carry out the important duty of overseeing clearing organizations in a changing, dynamic industry pursuant to a transparent codified framework.

EFFECTIVE DATE: February 12, 2001.

FOR FURTHER INFORMATION CONTACT: Alan L. Seifert, Deputy Director, Division of Trading and Markets, or Lois J. Gregory, Special Counsel, Division of Trading and Markets, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581. Telephone (202) 418–5260 or e-mail *PArchitzel@cftc.gov, ASeifert@cftc.gov,* or *LGregory@cftc.gov.*

SUPPLEMENTARY INFORMATION:

I. Background

On June 22, 2000, the Commission published for comment proposed new Part 39, a regulatory framework for the oversight of clearing organizations. 65 FR 39027. Part 39 is part of an initiative that would also establish a new regulatory framework for MTEFs and market intermediaries. The final new framework in its entirety is simultaneously announced today in companion releases. The new framework, including Part 39, is centered on broad, flexible, core principles and is designed to ''promote innovation, maintain U.S. competitiveness, and at the same time reduce systemic risk and protect customers.'' 65 FR 38986.

The futures and option markets are undergoing changes in market structure and technology. Clearing organizations for these markets perform valuable functions by mitigating counterparty risk, facilitating the netting and offsetting of contractual obligations, and decreasing systemic risk. Clearing organizations should be subject to continuing regulatory oversight to ensure that they have sufficient financial resources and that they establish and implement prudential risk management programs designed to control concentration risks associated with centralized clearing.[1] The Commission has fashioned new Part 39 so that it can fairly and efficiently carry out the important duty of overseeing clearing organizations in a changing, dynamic industry pursuant to a transparent codified framework.

Part 39 requires that transactions effected on recognized futures exchanges (RFEs) under Part 38 and derivatives transaction facilities (DTFs) under Part 37 be cleared only by clearing organizations that have been recognized by the Commission under Part 39—recognized clearing organizations (RCOs). RCOs are also permitted to clear transactions that are exempt under Part 35—Exemption of Bilateral Agreements and Part 36—Exemption of Transactions on Multilateral Transaction Execution Facilities.[2] In addition, nothing in Part 39 prohibits an RCO from clearing any other type of instrument such as cash or forward delivery contracts.[3]

Current futures clearing organizations may self-certify and automatically qualify as RCOs under Part 39. New entities could apply for RCO status by demonstrating that their rules, procedures, and operations would be consistent with the 13 broad and flexible core principles set forth in Part 39. Appendix A to Part 39 would provide guidance to applicant RCOs as to how to make such a demonstration. Certain provisions of Part 39 and Appendix A have been modified from their proposed versions in light of comments received from participants in the industry. These modifications, as discussed herein, provide additional clarity and are consistent with the new regulatory framework's goal of promoting innovation and maintaining U.S. competitiveness, while also reducing systemic risk and protecting customers.

II. Overview

The Commission received comment letters on Part 39 from a number of SROs and other interested entities.[4] Commenters overwhelmingly supported the Part 39 requirement that all transactions executed on a designated contract market, an RFE, or a DTF, if cleared, be cleared by an RCO. Commenters also supported the proposition that nothing in Part 39 prohibits RCOs from clearing transactions other than those effected pursuant to Parts 35–38. Other comments concerned the definition of clearing organization, the jurisdiction of the Commission, the applicable provisions of the Commodity Exchange Act (Act) and regulations, and the guidance in Appendix A to Part 39. In response to the comments, the Commission has made changes to the definition of clearing organization and changes that clarify the jurisdiction of the Commission under Part 39. Other changes to Part 39 limit the applicability of sections of the Act and the regulations, and address the illustrative purpose of the guidance in Appendix A.

III. Discussion

A. Purpose

The Part 39 core principles reflect standards that the Commission takes into account in overseeing the clearing of futures and option contracts without imposing new regulatory requirements. Certain commenters contended that Part 39 as proposed would impose a new regulatory framework on entities already successfully regulated, and that the Commission had not fully articulated why Part 39 was being imposed at this time. *See, e.g.,* CL 21–51 at 11 and CL 23–40 at 2.

The Commission currently oversees the clearing organizations that are associated or affiliated with U.S. futures and option exchanges. As a practical matter, the Commission generally has regulated clearing organizations in connection with its oversight of contract markets which heretofore have had close affiliations with their clearing organizations. Among other things, the Commission has reviewed clearing organization rules, audited clearing organizations for compliance with the Commission's segregation, recordkeeping, and customer funds investment rules, monitored the clearing process in times of major market moves to identify potential systemic risks, and conducted oversight of the liquidation of positions and transfer of customer accounts in cases where clearing members encounter financial difficulty.

The Commission's oversight of clearing organizations also has been guided by standards not expressly set forth in the Act or the Commission's regulations for contract markets. For example, the Commission has taken into account, among other standards and procedures, the standards set forth in the Bank for International Settlements' (BIS) 1993 Lamfalussy Report on multilateral netting systems and other BIS reports, the recommendations with respect to clearing and settlement of

[1] *See* Over-the-Counter Derivatives Markets and the Commodity Exchange Act, Report of the President's Working Group, November 1999.

[2] In addition to RCOs, certain other enumerated entities also are authorized to clear transactions exempt under Parts 35 and 36. These include a clearing agency or system regulated by the Securities and Exchange Commission (SEC), the Federal Reserve, or the Comptroller of the Currency, and certain foreign clearing organizations.

[3] Further, nothing in Part 39 prohibits an entity that clears only exempt transactions from applying to the Commission for RCO status. An entity may want to apply for recognition as an RCO for its own business purposes.

[4] In this and three companion Notices of Final Rulemaking which are being published in this edition of the **Federal Register**, comment letters (CL) are referenced by file number, letter number and page. These letters are available through the Commission's internet web site. Comments filed in response to the notice of proposed rulemaking on clearing organizations are contained in file No. 23. Comments filed predominantly in response to the notice of proposed rulemaking on Parts 36–38, but which also had comments on clearing organizations, are contained in file No. 21. Those commenting upon Part 39 include: Board of Trade Clearing Corporation (BOTCC); California Power Exchange; Chicago Board of Trade; Chicago Mercantile Exchange (CME); Federal Reserve Bank of Chicago (FRB of Chicago); Financial Markets Lawyers Group; Futures Industry Association (FIA); Global TeleExchange; Government Securities Clearing Corporation (GSCC); New York Independent System Operator; JP Morgan; Kiodex, Inc.; Mercatus Center at George Mason University; New York Clearing Corporation (NYCC); New York Mercantile Exchange; Options Clearing Corporation (OCC); Oxy Energy Services, Inc.; PetroCosm Corporation; Securities Industry Association; and Cleary, Gottlieb, Steen & Hamilton, on behalf of a coalition of investment banks consisting of Chase Manhattan Bank, Citigroup Inc., Credit Suisse First Boston Inc., Goldman Sachs & Co., Merrill Lynch & Co. Inc., and Morgan Stanley Dean Witter & Co. (Coalition).

securities transactions of the Group of Thirty, and the recommendations of the President's Working Group in response to the market break of October 1987. Part 39's core principles reflect these various standards and existing futures clearing organizations currently meet these standards. Thus, Part 39 represents the Commission's intention to put into a logical and coherent regulatory form the same principles that the Commission now applies to clearing organizations. This approach is a natural accompaniment to the new regulatory framework.

Recently, there has been an increase in the number of new electronic markets that do not have their own clearing capacity. This trend has resulted in an increase in the opportunity for clearing organizations independent of transaction facilities to clear for multiple markets, which in turn magnifies the importance of clearing in the management of systemic risk. Clearing organizations unaffiliated with the transaction facilities for which they clear necessarily will have rules, procedures, and practices separate and independent from the transaction facilities. Thus, the Commission will oversee the clearing function pursuant to a framework separate from, but related to, the framework for the oversight of the transaction facilities.

B. Definition of Clearing Organization

In its final Part 39 rules, the Commission has clarified the definition of ''clearing organization'' to mean, with respect to transactions executed on a designated contract market or pursuant to Parts 35–38, a person that provides credit enhancement to its members or participants in connection with netting and/or settling the payments and payment obligations of such members or participants, by becoming a universal counterparty to such members or participants, or otherwise.[5] Providing credit enhancement in connection with, or as a byproduct of, providing settlement services is the critical attribute of a clearing organization.

Some of the comments raised concerns about the proposed definition in that they stated certain activities should not constitute the activity of clearing. *See, e.g.,* BOTCC CL 21–20 at 10. These activities include the netting of payment obligations and entitlements and the performance of trade processing services such as trade comparison, margin calculation, and reporting services.[6] In response to these comments, the revised definition captures only organizations whose services enhance the credit of the members or participants that are parties to the contracts cleared by the organization.

One method of credit enhancement is to be the counterparty to every cleared transaction. The clearing organization substitutes itself for each original counterparty and becomes legally bound to every party to a transaction. This is known as legal novation. However, a clearing organization can provide credit enhancement in ways other than strict legal novation. It can agree with its members and participants that it will be legally bound to guarantee payment flows associated with transactions in connection with or as a byproduct of the provision of netting services, that is, the netting of all payment obligations and entitlements. A clearing organization also could provide credit enhancement in any legal agreement to guarantee payment flows in connection with other settlement services.

The provision of one or more clearing services absent credit enhancement, however, will not, as a general matter, constitute the activity of clearing for purposes of Part 39. Therefore, for purposes of Part 39, the term ''clearing organization'' does not encompass the sole provision of netting services in the absence of any type of credit enhancement.

C. Scope of Part 39

The language of the scope provision, § 39.1, the enforceability provision, § 39.5, and the antifraud provision, § 39.6, in their final form, all apply to an RCO's *clearing* of transactions effected pursuant to the enumerated parts. The final language of § 39.2 clarifies:

(1) what must be cleared by an RCO (any transaction effected on a contract market or pursuant to Parts 37 and 38 that is cleared);

(2) that the *clearing of* transactions by an RCO is regulated under Part 39;

(3) that transactions effected pursuant to Parts 35 or 36 may be cleared by an RCO or by other authorized clearing organizations;[7]

(4) that the *clearing of* transactions effected pursuant to Parts 35 or 36 by an RCO is regulated under Part 39;

(5) that the clearing of transactions effected pursuant to Parts 35 or 36 by authorized clearing organizations other than an RCO is not regulated under Part 39; and

(6) that transactions not specified in 39.1(a) may also be cleared by an RCO.

The changes to the scope, enforceability and antifraud provisions address commenters' concerns that: (1) proposed Part 39 could be interpreted to apply the Act and the Commission's regulations to transactions outside the appropriate scope of Part 39, such as cash products or other products beyond the authority of the Act, *see, e.g.,* CME CL 21–51 at 9–10; (2) it may appear as if the Commission is attempting to expand its jurisdiction to include any over-the-counter transaction that is submitted to an RCO for clearing, *id.*; (3) the new part should clarify that transactions effected pursuant to Parts 35 or 36 do not become subject to the jurisdiction of the Commission simply because they are submitted to a Part 39 clearing organization and that clearing does not, by itself, make an exempt transaction subject to the Act, *see* BOTCC CLs 21–6 at 4 and 21–20 at 8; and (4) the effect of § 39.6 would not be the assertion of the Commission's enforcement authority over otherwise-exempt transactions simply because those transactions are submitted to clearing. As proposed, § 39.6 prohibited fraud in connection with any transaction cleared by an RCO. The final section prohibits fraud in connection with the *activity* of clearing. *See* BOTCC CL 21–6 at 4, FRB of Chicago CL 23–25 at 7 and GSCC CL 23–19 at 4.

As discussed, the final Part 39 rules address these comments. The Commission is not hereby asserting jurisdiction over transactions in cash and other products not subject to the Act. Commission oversight of an RCO under Part 39 addresses the clearing process only and does not include regulation or oversight of the transactions or the traders. The Commission, however, notes that it must monitor for the potential that clearing of cash and other products not subject to the Act could adversely affect the viability, risk exposure, and management of the entity as an RCO.[8]

[5] The definition continues to exclude those netting arrangements specified in § 35.2 (d)(1) and (d)(2) and an entity that is a single counterparty offering to enter into, or entering into, bilateral transactions with multiple counterparties.

[6] It also includes, where applicable, the scheduling or netting of physical delivery obligations and related bookkeeping functions such as those performed by operators of physical delivery points for certain energy-related products. *See* CL 21–56 at 2.

[7] Transactions pursuant to Part 34 are not included in 39.2 or otherwise referred to in Part 39 as these instruments have consistently been subject to other regulatory schemes, whether under the jurisdiction of the SEC as securities, or regulated pursuant to federal banking laws as depository instruments.

[8] An analogy can be drawn to the interest the Commission has in assessing risk presented to futures commission merchants (FCMs) by their non-futures activities. Thus, for example, the Commission's net capital rule has provisions relating to the capital treatment of securities and

D. Treatment as Contract Market

As proposed, § 39.1(b)(2) provided that an RCO would be deemed to be a contract market for purposes of the Act and the regulations, but would be exempt from all such provisions except as reserved in § 39.5. In its final rules, the Commission has combined the language of proposed § 39.1(b)(2) with proposed § 39.5. Section 39.5 now provides that an RCO is deemed to be a contract market *to the extent it clears transactions specified in § 39.1(a)* (the scope provision), but is exempt from all provisions of the Act and regulations except, *as applicable,* certain enumerated sections of the Act and the Commission's regulations which would continue to apply.

Combining the separate provisions and amending the resulting § 39.5 as indicated, limits the purpose for which RCOs are deemed to be contract markets and addresses commenters' concern that the provision would subject clearing organizations to provisions of the Act and the Commission's regulations that do not now apply. *See, e.g.,* BOTCC CL 21–6 at 4. Pursuant to the final rule, an RCO is deemed to be a contract market only to the extent it clears those transactions specified in § 39.1(a). Further, even though an RCO is deemed to be a contract market to this limited extent, § 39.5 exempts it from all provisions of the Act and regulations, except the sections enumerated, and only to the extent those enumerated sections are applicable to the activity of clearing § 39.1(a) transactions.

In reserving the sections of the Act and the regulations enumerated in § 39.5, the Commission is not asserting that any of those sections or regulations would be applicable to an RCO under any particular circumstances. The Commission only seeks, conservatively, to reserve those sections of the Act and regulations that may need to be applied to an RCO in order to achieve compliance with the core principles set forth in Part 39. The reservations in § 39.5 of Sections 4b and 4o of the Act and Rule 33.10 will subject RCOs to the same standard with respect to fraud and manipulation in connection with the clearing of transactions to which clearing organizations are currently subject. *See* FIA CL 23–26 at 5. Reservation of the enumerated sections of the Act or regulations, including specifically Section 4i of the Act and Rule 1.38(a), will not render RCOs responsible for the enforcement of any new or additional regulatory requirements, nor increase the liability of clearing organizations under Section 22 of the Act. *See* BOTCC CLs 21–20 at 7 and 21–6 at 4.

E. Competitive Issues

Commenters strongly agreed with the requirement in § 39.2 that all transactions effected on a contract market, RFE, or DTF, if cleared, must be cleared by an RCO. For example, the CME expressed its agreement with the result that a clearing organization that either is governed by another regulator, or has no regulator, is prohibited from clearing such products. CL 21–51 at 10. However, many commenters raised concerns regarding the effect of Part 39 on the ability of RCOs to compete with other types of clearing organizations. The commenters stated that allowing clearing organizations other than RCOs, including clearing organizations regulated by the SEC, to clear transactions effected pursuant to Parts 35 or 36, will give clearing organizations other than RCOs the ability to clear the full spectrum of financial transactions—cash, securities, options, futures (if traded on an exempt MTEF) and other derivatives. They further stated that the SEC, however, will not allow an RCO that is not also registered as a clearing agency with the SEC to clear transactions in securities. *Id.* Commenters thought the proposal grants an unfair exemption to securities clearinghouses, banks, bank affiliates, and foreign clearinghouses from the substantive requirements that otherwise would apply to RCOs. CLs 21–6 at 5, 21–20 at 5, 23–26 at 7, and 21–36 at 6.

In authorizing particular clearing organizations in addition to RCOs to clear transactions pursuant to Parts 35 and 36, the Commission is adopting the unanimous recommendations made in the report of the President's Working Group.[9] The Commission notes that it has made revisions elsewhere in its new regulatory framework (*i.e.,* the final rules under Parts 35–38) that lessen the impact of these concerns in some instances. Under final rules adopted by the Commission in response to comments made by the U.S. Department of the Treasury, transactions based on U.S. government securities are not eligible for trading on exempt MTEFs.[10] Under part 39, only RCOs can clear transactions effected on DTFs or RFEs.

F. Application of Core Principles and Appendix A

1. General

RCO applicants must demonstrate compliance with each of the core principles of Part 39 as a condition of recognition. These principles will not subject RCOs to any regulatory requirement not now applicable to futures clearing organizations under the Commission's current oversight. Each of the core principles must be addressed, but the guidance in Appendix A to Part 39 is intended only to be illustrative of the types of matters an applicant may address in order to satisfactorily demonstrate that it meets the core principles.

The final appendix clarifies the purpose of the guidance in response to commenters' concerns regarding the level of specificity in Appendix A. Commenters were concerned that the guidance would take on the force of law, applicants would have to affirmatively demonstrate compliance with each provision, and clearing organizations would be subject to far greater regulatory compliance burdens than before. *See, e.g.,* FIA CL 23–26 at 4 and BOTCC CL 21–20 at 10. Appendix A expressly makes clear that it is neither a checklist of issues that an applicant is required to address nor an exclusive list of matters from which an applicant can choose applicable components to address. Rather, the appendix provides detailed non-binding guidance that applicants can use as a tool in demonstrating satisfaction of the core principles.

In order to become recognized under Part 39, current futures clearing organizations need only submit a certification that their rules, procedures and operations fulfill the conditions for recognition under Part 39.[11] All of the current futures clearing organizations could become recognized in this

other non-futures inventory held by an FCM in the normal course of its business. *See* Commission Regulation 1.17. *See also* Commission Regulations 1.14 and 1.15 that assess risk to a registered FCM from affiliates in its holding company system.

[9] Over-the-Counter Derivatives Markets and the Commodity Exchange Act, Report of the President's Working Group, November 1999. The group, whose members were signatories to the report, includes 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.

[10] Specifically, the Commission has removed the reference to exempt securities and indexes thereof previously included in proposed Rule 36.2(b)(4) and has amended final Rule 36.2(b)(1) to make clear that eligible debt instruments do not include such exempt securities.

[11] Although § 39.4(a) allows only nondormant entities, as defined, to self-certify, the Commission is prepared to accept the certification of the Intermarket Clearing Corporation (ICC) under this provision. ICC is a wholly-owned subsidiary of the Options Clearing Corporation. Commission staff is familiar with ICC's rules and operations. ICC has maintained its clearing systems, rules, and banking and other arrangements in place and remains fully prepared operationally to clear transactions in futures contracts in accordance with its rules.

manner. They are not required to address affirmatively any of the separate core principles (and none of the suggested guidance in Appendix A).

2. The Core Principles

The final rules contain changes that address commenters' views concerning the wording and applicability of particular core principles. Commenters requested that Core Principle 2, which deals with participant and product eligibility, be revised to eliminate product eligibility criteria for instruments that an RCO will accept for clearing. Commenters contended that this requirement was impractical, would require an extraordinary degree of prognostication and would best be dealt with on a case-by-case basis by an RCO, considering all relevant circumstances. BOTCC CL 21–20 at 13. The Commission has revised the final core principle and the accompanying appendix guidance accordingly.

Several commenters thought that Core Principle 7 on enforcement inappropriately required arrangements and resources for resolution of disputes and encouraged the Commission to eliminate it from the principle. *See, e.g.,* NYCC CL 23–40 at 4 and GSCC 23–19 at 4. The Commission has considered the commenters' concerns that this requirement would impose a new and inappropriate burden on RCOs, but has determined to retain it in the core principle with the added qualification of ''as applicable.'' The Commission does not wish to rule out the possible appropriateness of some form of dispute resolution at RCOs as the industry continues to evolve. By qualifying the item with its applicability, RCO applicants can choose to address whether and why they do or do not have a dispute resolution program in demonstrating that they will be able to effectively enforce their rules.

The final version of the other core principles contains modifications that serve to increase their intended breadth and flexibility. For example, Core Principle 1, which deals with financial resources, as proposed, required adequate capital resources to fulfill its guarantee function without interruption in various market conditions. At the suggestion of one of the commenters, the final version of Core Principle 1 requires adequate financial resources to fulfill its guarantee function without interruption in *reasonably foreseeable* market conditions. *See* Coalition CL 23–41 at 24. In addition, Core Principle 14 concerning competition has been revised. The Commission does not want to inadvertently impose duties on an applicant that differ in form or degree from the antitrust statutes and court decisions construing federal antitrust laws. *See* BOTCC CL 21–20 at 13. Thus, final Core Principle 14 simply requires RCOs to operate in a manner consistent with the public interest to be protected by the antitrust laws. This language comes directly from Section 15 of the Act which the Commission has reserved in § 39.5. The requirements of Section 15 remain the responsibility of the Commission and the Commission intends to apply Section 15 to antitrust issues in the same manner as previously applied.

Core Principle 12 regarding public disclosure of certain operating procedures of an RCO was not revised in response to concerns regarding confidentiality. An RCO, however, will not be required under this core principle to disclose trade secrets.

3. The Guidance in Appendix A

Commenters also expressed opinions about the applicability and wording of particular proposed guidance in Appendix A. Many of these concerns are addressed by language in the final appendix that states the guidance is only illustrative of the types of matters an applicant may address in order to demonstrate that it meets the core principles and is not intended to be a mandatory checklist of issues to address. If particular guidance does not apply to an RCO applicant, it may either not address it or explain why it does not apply. Applicants also are strongly encouraged to address relevant matters other than those contained in the guidance suggested in the appendix if doing so would assist the applicant in demonstrating compliance with a particular core principle.

The Commission has modified certain of the guidance in response to commenters' concerns regarding the appropriateness or applicability of particular guidance language. In response to comments that the Commission does not have the authority to review the setting of levels of margin, the Commission revised guidance regarding the determination of appropriate margin levels for a cleared contract and the clearing member clearing the contract. *See, e.g.,* FIA CL 23–26 at 4. The final version of this guidance suggests that an applicant may describe the process by which it would determine appropriate margin levels for an instrument that it clears and its clearing members. This information is highly relevant and could be used by an applicant for RCO status to assist in demonstrating that it meets the third core principle concerning the ability to manage risks associated with carrying out the guarantee function.

Several comments addressed the appropriateness of the proposed guidance under Core Principle 6 concerning default rules and procedures. The guidance suggested that applicants describe rules and procedures regarding priority of customer accounts over proprietary accounts and, where applicable, in the context of other programs such as specialized margin reduction programs like cross-margining. Commenters argued that given the successful operation of cross-margining programs, it is inappropriate for the accounts of cross-margining participants to be subordinated to the accounts of market participants not participating in cross-margining programs. OCC CL 23–23 at 2, 3. The Commission has considered this argument and although it recognizes that cross-margining programs have been successful and can operate to reduce risks, including risk of participant default, it has determined to retain this guidance in the final Appendix A. The guidance is appropriate in that it only suggests that an applicant RCO that is proposing or contemplating being a party to a margin reduction program such as cross-margining address in its application whether and why a priority rule would or would not be present in any particular margin reduction program. It does not require such a priority rule. This information will provide relevant and useful information to the Commission in assessing the applicant's overall compliance with all aspects of Core Principle 6.

The Commission modified other guidance under various core principles in response to comments received. For example, the final guidance under Core Principle 8 dealing with system safeguards suggests that an applicant may confirm that system testing and review has been performed by a qualified independent professional, and not specifically by a member of the Information Systems Audit and Control Association. A professional that is a certified member of the Information Systems Audit and Control Association experienced in the industry, however, is referred to as an example of an acceptable party to carry out such testing and review. *See* CL 21–20 at 10. In addition, the Commission has modified the guidance for Core Principle 9 relating to governance to note that an RCO, consistent with longstanding Commission policy, may not limit liability for violation of the Act or Commission rules, fraud, or wanton or willful misconduct. This requirement

currently applies to designated contract markets.

G. Other Comments

Certain commenters suggested that the Commission restrict the length of time that a proposed RCO rule could be stayed under Commission Regulation 1.41. *See e.g.,* CL 21–20 at 12. The Commission anticipates that it only will impose a stay of an RCO rule in limited and potentially egregious situations. In fact, the Commission would only be able to stay a proposed rule incident to disapproval proceedings and the stay determination would not be delegable to Commission staff. Since a rule only would be stayed incident to a disapproval proceeding, the length of any stay would not be indeterminate in any event.

Certain commenters raised questions as to whether bankruptcy provisions that are currently applicable to transactions conducted on a contract market could also be applicable to all transactions cleared by an RCO. *See, e.g.,* CL 21–65 at 23. Part 39 reserves the applicability of Part 190 to the activity of clearing § 39.1(a) transactions, *if applicable*. Part 190 in conjunction with the commodity broker liquidation provisions of Subchapter IV of Chapter 7, Title 11 of the Federal Bankruptcy Code, apply to an insolvency when the insolvent party is a ''commodity broker'' (typically an FCM or clearing organization that has any futures accounts), as defined under Title 11. If an RCO does not have open futures accounts it would not be covered by SubChapter IV.

IV. Section 4(c) Findings

These final rules are being promulgated under Section 4(c) of the Act, which grants the Commission broad exemptive authority. Section 4(c) of the Act provides that, in order to promote responsible economic or financial innovation and fair competition, the Commission may by rule, regulation or order, exempt any class of agreements, contracts or transactions, including any person or class of persons offering, entering into, rendering advice or rendering other services with respect to, the agreement, contract, or transaction, from the contract market designation requirement of Section 4(a) of the Act, or any other provision of the Act other than Section 2(a)(1)(B), if the Commission determines that the exemption would be consistent with the public interest. Furthermore, Section 4(c)(2) of the Act provides that the Commission may not grant an exemption from the contract market designation requirement of Section 4(a) of the Act unless the Commission also finds that: (i) the contract market designation requirement should not be applied to the agreement, contract, or transaction for which the exemption is requested and the exemption would be consistent with the public interest and the purposes of the Act; (ii) the exempted transaction will be entered into solely between ''appropriate persons''; and (iii) the agreement, contract, or transaction in questions will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the Act.

As explained above, Part 39 is part of a new regulatory framework. The new framework is intended to promote innovation and competition in the trading of derivatives and to permit the markets the flexibility to respond to technological and structural changes. Specifically, Part 39 replaces Commission regulation of clearing organizations through the current more formal designation and regulation of contract markets. It provides for a streamlined procedure for clearing organizations to obtain recognition by meeting broad, non-prescriptive core principles. It permits recognized clearing organizations the flexibility to clear regulated, exempt, and unregulated transactions. It also authorizes clearing organizations regulated by other regulatory bodies to clear certain transactions. The core principle approach set forth in Part 39 strikes an appropriate balance between applying necessary regulatory protections to the critical market functions of clearing and facilitating the development of varied clearing mechanisms and structures. Accordingly, the Commission believes that Part 39 is consistent with the public interest, is consistent with the purposes of the Act, will be applicable only to appropriate persons, and would have no adverse effect on the regulatory or self-regulatory responsibilities imposed by the Act.

V. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA), 5 U.S.C. 601 *et seq.,* requires that agencies, in promulgating rules, consider the impact of those regulations on small entities. The rules adopted herein would affect certain clearing organizations. The Commission has stated that it is appropriate to evaluate within the context of a particular rule whether some or all of affected entities should be considered small entities and, if so, to analyze the economic impact on them of any rule. In this regard, the rules being adopted herein would not require any current futures clearing organization to change any aspect of its operation or take any action other than to submit a certification. The rules being adopted replace regulation of clearing organizations through the formal designation and regulation of contract markets with a streamlined procedure for clearing organizations, regardless of size, to obtain recognition by meeting broad, non-prescriptive core principles. Accordingly, the Chairman, on behalf of the Commission, hereby certifies, pursuant to 5 U.S.C. 605(b), that the action taken herein will not have a significant economic impact on a substantial number of small entities. In this regard, the Commission notes that it did not receive any comments regarding the RFA implications of Part 39.

B. Paperwork Reduction Act

Part 39 contains information collection requirements. As required by the Paperwork Reduction Act of 1995, 44 U.S.C. 3501 *et seq*., the Commission submitted a copy of this part to the Office of Management and Budget (OMB) for its review. *See* 44 U.S.C. § 3507(d). No comments were received in response to the Commission's invitation in the proposing release to comment on any potential paperwork burden associated with this regulation.

List of Subjects in 17 CFR Part 39

Clearing, Clearing Organizations, Commodity Futures, Consumer Protection.

In consideration of the foregoing, and pursuant to the authority contained in Sections 2, 6(c), 7a, and 12a(5) of the U.S.C., the Commission hereby amends Chapter I of Title 17 of the Code of Federal Regulations by adding part 39 to read as follows:

PART 39—RECOGNIZED CLEARING ORGANIZATIONS

Sec.

Authority: 7 U.S.C. 2, 6(c), 6d(2), 6g, 7a, 12a(5).

§ 39.1 Scope and definitions.

(a) *Scope.* The provisions of this part 39 apply to a recognized clearing organization that clears transactions effected on or through a designated contract market, a recognized futures exchange under part 38 of this chapter, a derivatives transaction facility under part 37 of this chapter, an exempt multilateral transaction execution facility under part 36 of this chapter, and to exempt bilateral transactions under part 35 of this chapter.

(b) *Definitions.* For purposes of this part:

(1) *Clearing organization* means a person that provides a credit enhancement function with respect to transactions executed on a designated contract market or pursuant to Parts 35 through 38 of this chapter in connection with netting and/or settling the payments and payment obligations of such members or participants, by becoming a universal counterparty to such members or participants, or otherwise; but does not include those netting arrangements specified in § 35.2(d)(1) and (d)(2), nor does it include an entity that is a single counterparty offering to enter into, or entering into bilateral transactions with multiple counterparties.

(2) *Recognized clearing organization* means a clearing organization that has been recognized by the Commission under § 39.3.

§ 39.2 Permitted clearing.

(a) Any transaction effected on a designated contract market, recognized futures exchange, or derivatives transaction facility, if cleared, shall be cleared by a recognized clearing organization. The clearing of transactions by a recognized clearing organization shall be governed by the provisions of this part.

(b) A transaction effected pursuant to part 35 or part 36 of this chapter, if cleared, shall meet the requirements of § 35.2(c) or § 36.2(c) of this chapter, as applicable, if the transaction is cleared by one of the following authorized clearing organizations:

(1) A recognized clearing organization;

(2) A securities clearing agency subject to the supervisory jurisdiction of the Securities and Exchange Commission;

(3) A clearing system organized as a bank, bank subsidiary, affiliate of a bank, or Edge Act corporation established under the Federal Reserve Act authorized to engage in international banking or financial activities, and subject to the jurisdiction of the Federal Reserve or Comptroller of the Currency; or

(4) A foreign clearing organization that demonstrates to the Commission that it:

(i) Is subject to home country regulation and oversight comparable to the standards set forth by the Commission for recognition of clearing organizations under this part; and

(ii) Is a party to and abides by appropriate and adequate information-sharing arrangements.

(c) The clearing of transactions effected pursuant to part 35 or part 36 of this chapter by a recognized clearing organization shall be governed by the provisions of this part. The provisions of this part shall not apply to the clearing of transactions effected pursuant to part 35 or part 36 by an authorized clearing organization other than a recognized clearing organization.

(d) Nothing in this part prohibits clearing by a recognized clearing organization of transactions not specified in § 39.1(a).

§ 39.3 Conditions for recognition as a recognized clearing organization.

To be recognized by the Commission under this part 39 as a recognized clearing organization, an entity:

(a) Need not be affiliated with a designated contract market or recognized futures exchange under part 38 of this chapter, derivatives transaction facility under part 37 of this chapter, or exempt multilateral transaction execution facility under part 36 of this chapter;

(b) Must have rules and procedures relating to its governance and to the operation of its clearing function; and

(c) Must initially, and on a continuing basis, meet and adhere to the following core principles:

(1) *Financial resources:* Have adequate financial resources to fulfill its guarantee function without interruption in reasonably foreseeable market conditions.

(2) *Participant eligibility:* Have appropriate admission and continuing eligibility standards for members or participants of the organization.

(3) *Risk management:* Have the ability to manage the risks associated with carrying out its guarantee function through the use of tools and procedures appropriate under the circumstances.

(4) *Settlement procedures:* Have the ability to complete settlements on a timely basis under varying circumstances, to maintain an adequate record of the flow of funds associated with the transactions it clears, and, to the extent applicable, to comply with the terms and conditions of any netting or offset arrangements with other clearing organizations.

(5) *Treatment of member and participant funds:* Have adequate procedures designed to protect the safety of member and participant, and as applicable, customer funds held by the clearing organization.

(6) *Default rules and procedures:* Have rules and procedures designed to allow for the effective and fair management of events when members or participants become insolvent or otherwise default on their obligations to the clearing organization.

(7) *Rule enforcement:* Have arrangements and resources for the effective monitoring and enforcement of compliance with its rules and, as applicable, for resolution of disputes.

(8) *System safeguards:* Have a program of testing, oversight, and risk analysis to ensure that its automated systems function properly and have adequate capacity, security, emergency, and disaster recovery procedures.

(9) *Governance:* Have appropriate fitness standards for owners or operators with greater than ten percent interest or an affiliate of such an owner, and for members of the governing board, and a means to address conflicts of interest in making decisions.

(10) *Reporting:* Provide all information requested by the Commission for it to conduct its oversight function of the clearing organization's activities.

(11) *Recordkeeping:* Keep full books and records of all activities relating to its business as a recognized clearing organization in a form and manner acceptable to the Commission for a period of five years, during the first two of which the books and records are readily available, and which shall be open to inspection by any representative of the Commission or the U.S. Department of Justice.

(12) *Public information:* Publicly disclose information concerning the rules and operating procedures governing its clearing and settlement systems, including default procedures.

(13) *Information sharing:* Participate in domestic and international information-sharing agreements as appropriate and use information obtained from such agreements in carrying out the clearing organization's risk management program.

(14) *Competition:* Operate in a manner consistent with the public interest to be protected by the antitrust laws.

§ 39.4 Procedures for recognition.

(a) *Recognition by certification.* A clearing organization that cleared for at least one nondormant contract market

within the meaning of § 5.3 of this chapter on February 12, 2001, will be recognized by the Commission as a recognized clearing organization upon receipt by the Commission at its Washington, DC, headquarters of a copy of the clearing organization's current rules and a certification by the clearing organization that it meets the conditions for recognition under this part.

(b) *Recognition by application.* A clearing organization shall be recognized by the Commission as a recognized clearing organization sixty days after receipt by the Commission of an application for recognition unless notified otherwise during that period, if:

(1) The application demonstrates that the applicant satisfies the conditions for recognition under this part;

(2) The submission is labeled as being submitted pursuant to this part;

(3) The submission includes a copy of the applicant's rules and, to the extent that compliance with the conditions of recognition is not self-evident, a brief explanation of how the rules satisfy each of the conditions for recognition under § 39.3;

(4) The applicant does not amend or supplement the application for recognition, except as requested by the Commission or for correction of typographical errors, renumbering or other nonsubstantive revisions, during that period; and

(5) The applicant has not instructed the Commission in writing during the review period to review the application pursuant to procedures under section 6 of the Act.

(6) Appendix A to this part is guidance to applicants concerning how the core principles set forth in this paragraph (b) could be satisfied.

(c) *Termination of part 39 review.* During the sixty-day period for review pursuant to paragraph (b) of this section, the Commission shall notify the applicant seeking recognition that the Commission is terminating review under this section and will review the proposal under the procedures of section 6 of the Act, if it appears that the application fails to meet the conditions for recognition under this part. This termination notification will state the nature of the issues raised and the specific condition of recognition that the application appears to violate, is contrary to, or fails to meet. Within ten days of receipt of this termination notification, the applicant seeking recognition may request that the Commission render a decision whether to recognize the clearing organization or to institute a proceeding to disapprove the proposed submission under procedures specified in section 6 of the Act by notifying the Commission that the applicant seeking recognition views its submission as complete and final as submitted.

(d) *Delegation of authority.* (1) The Commission hereby delegates to the Director of the Division of Trading and Markets or the Director's delegatee, with the concurrence of the General Counsel or the General Counsel's delegatee, authority to notify an entity seeking recognition under paragraph (b) of this section that review under those procedures is being terminated.

(2) The Director of the Division of Trading and Markets may submit to the Commission for its consideration any matter which has been delegated in this paragraph.

(3) Nothing in the paragraph prohibits the Commission, at its election, from exercising the authority delegated in paragraph (d)(1) of this section.

(e) *Request for Commission approval of rules.* (1) An applicant for recognition as a recognized clearing organization may request that the Commission approve any or all of its rules and subsequent amendments thereto, at the time of recognition or thereafter, under section 5a(a)(12) of the Act and § 1.41 of this chapter. The recognized clearing organization may label such rules as having been approved by the Commission.

(2) Rules of a recognized clearing organization that have not been submitted pursuant to paragraph (a) or (b)(3) of this section shall be submitted to the Commission pursuant to § 1.41 of this chapter.

(3) An applicant seeking recognition as a recognized clearing organization may request that the Commission consider under the provisions of section 15 of the Act any of the entity's rules or policies at the time of recognition or thereafter.

(f) *Request for withdrawal of recognition.* A recognized clearing organization may withdraw from Commission recognition by filing with the Commission at its Washington, DC headquarters such a request. Withdrawal from recognition shall not affect any action taken or to be taken by the Commission based upon actions, activities, or events occurring during the time that the clearing organization was recognized by the Commission.

§ 39.5 Enforceability.

To the extent it clears transactions specified in § 39.1(a), a recognized clearing organization shall be deemed to be a contract market for purposes of the Act and the Commission rules thereunder; *provided, however,* a recognized clearing organization shall be exempt from all provisions of the Act and Commission regulations except, as applicable, sections 1a, 2(a)(1), 4, 4b, 4c, 4d, 4g, 4i, 4o, 5(6), 5(7), 5a(a)(1), 5a(a)(2), 5a(a)(8), 5a(a)(9), the rule disapproval procedures of section 5a(a)(12), 5a(a)(16), 5a(a)(17), 6(a), 6(c) to the extent it prohibits manipulation of the market price of any commodity in interstate commerce or for future delivery on or subject to the rules of any contract market, 8a(7), 8a(9), 8c(a), 8c(b), 8c(c), 8c(d), 9(a), 9(f), 14, 15, 20 and 22 of the Act and §§ 1.3, 1.20, 1.24, 1.25, 1.26, 1.27, 1.29, 1.31, 1.36, 1.38, 1.41, parts 15 through 21, § 33.10, this part 39, and part 190 of this chapter, which continue to apply.

§ 39.6 Fraud in connection with the clearing of transactions by a recognized clearing organization.

It shall be unlawful for any person, directly or indirectly, in or in connection with the clearing of any transaction specified in § 39.1(a) by a recognized clearing organization:

(a) To cheat or defraud or attempt to cheat or defraud any other person;

(b) Willfully to make or cause to be made to any other person any false report or statement thereof or cause to be entered for any person any false record thereof; or

(c) Willfully to deceive or attempt to deceive any other person by any means whatsoever.

Appendix A to Part 39—Application Guidance

This appendix provides guidance to applicants for recognition as recognized clearing organizations in connection with satisfying each of the core principles of § 39.4. This appendix is only illustrative of the types of matters an applicant may address, as applicable, in order to demonstrate satisfactorily that it meets the core principles and is not intended to be a mandatory checklist of issues to address.

Core Principle 1—Financial Resources. Have adequate financial resources to fulfill its guarantee function without interruption in reasonably foreseeable market conditions.

In addressing core principle 1, applicants may describe or otherwise document:

1. The amount of resources dedicated to supporting the clearing function:

a. The amount of resources available to the clearing organization and the sufficiency of those resources to assure that no break in clearing operations would occur in a variety of market conditions; and

b. The level of member/participant default such resources could support as demonstrated through use of hypothetical default scenarios that explain assumptions and variables factored into the illustrations.

2. The nature of resources dedicated to supporting the clearing function:

a. The type of the resources, including their liquidity, and how they could be

accessed and applied by the clearing organization promptly; and

b. Any legal or operational impediments or conditions to access.

Core Principle 2—Participant Eligibility. Have appropriate admission and continuing eligibility standards for members or participants of the organization.

In addressing core principle 2, applicants may describe or otherwise document:

1. Member/participant admission criteria:

a. How admission standards for its clearing members would contribute to the soundness and integrity of operations; and

b. Matters such as whether these criteria would be in the form of organization rules that apply to all clearing members, whether different levels of membership would relate to different levels of net worth, income, and creditworthiness of members, and whether margin levels, position limits and other controls would vary in accordance with these levels.

2. Member/participant continuing eligibility criteria:

a. A program for monitoring the financial status of its members; and

b. Whether and how the clearing organization would be able to change continuing eligibility criteria in accordance with changes in a member's financial status.

3. The clearing function for each instrument the organization undertakes to clear.

Core Principle 3—Risk Management. Have the ability to manage the risks associated with carrying out its guarantee function through the use of tools and procedures appropriate under the circumstances.

In addressing core principle 3, applicants may describe or otherwise document:

1. Use of risk analysis tools and procedures:

a. How the adequacy of the overall level of financial resources would be tested on an ongoing periodic basis in a variety of market conditions; and

b. How the organization would use specific risk management tools such as stress testing and value at risk calculations.

2. Use of collateral:

a. How appropriate forms and levels of collateral would be established and collected;

b. How amounts would be adequate to secure prudentially obligations arising from clearing transactions and performing as a central counterparty;

c. The process for determining appropriate margin levels for an instrument cleared and for clearing members;

d. The appropriateness of required or allowed forms of margin given the liquidity and related requirements of the clearing organization;

e. How the clearing organization would value open positions and collateral assets; and

f. The proposed margin collection schedule and how it would relate to changes in the value of market positions and collateral values.

3. Use of credit limits: If and how systems would be implemented that would prevent members and other market participants from exceeding credit limits.

4. Use of cross-margin programs: How collateral assets subject to cross-margining programs would provide, where applicable, for clear, fair, and efficient loss-sharing arrangements in the event of a program participant default.

Core Principle 4—Settlement Procedures. Have the ability to complete settlements on a timely basis under varying circumstances, to maintain an adequate record of the flow of funds associated with the transactions it clears, and, to the extent applicable, to comply with the terms and conditions of any netting or offset arrangements with other clearing organizations.

In addressing core principle 4, applicants may describe or otherwise document:

1. Settlement timeframe:

a. Procedures for completing settlements on a timely basis during times of normal operating conditions; and

b. Procedures for completing settlements on a timely basis in varying market circumstances including during a period when a significant participant or member has defaulted.

2. Recordkeeping:

a. The nature and quality of the information collected concerning the flow of funds involved in clearing and settlement; and

b. How such information would be recorded, maintained and accessed.

3. Interfaces with other clearing organizations: How compliance with the terms and conditions of netting or offset arrangements with other clearing organizations would be met, including, among others, common banking or common clearing programs.

Core Principle 5—Treatment of Member and Participant Funds. Have adequate procedures designed to protect the safety of member and participant, and as applicable, customer funds held by the clearing organization.

In addressing core principle 5, applicants may describe or otherwise document:

1. Safe custody:

a. The safekeeping of funds, whether in accounts, in depositories, or with custodians, and how it would meet industry standards of safety;

b. Any written terms regarding the legal status of the funds and the specific conditions or prerequisites for movement of the funds; and

c. The extent to which the deposit of funds in accounts in depositories or with custodians would limit concentration of risk.

2. Segregation between customer and proprietary funds: Requirements or restrictions regarding commingling customer with proprietary funds, obligating customer funds for any purpose other than to purchase, clear, and settle the products the clearing organization is clearing, or which are subject to cross-margin or similar agreements, and any other aspects of customer fund segregation.

3. Investment standards: How customer funds would be invested consistent with high standards of safety and associated recordkeeping regarding the details of such investments.

Core Principle 6—Default Rules and Procedures. Have rules and procedures designed to allow for the effective and fair management of events when members or participants become insolvent or otherwise default on their obligations to the clearing organization.

In addressing core principle 6, applicants may describe or otherwise document:

1. Definition of default:

a. The definition of default and how it would be established and enforced; and

b. How the applicant would address failure to meet margin requirements, the insolvent financial condition of a member or participant, failure to comply with certain rules, failure to maintain eligibility standards, actions taken by other regulatory bodies, or other events.

2. Remedial action: The authority pursuant to which, and how, the clearing organization may take appropriate action in the event of the default of a member which may include, among other things, closing out positions, replacing positions, set-off, and applying margin.

3. Process to address shortfalls: Procedures for the prompt application of clearing organization and/or member financial resources to address monetary shortfalls resulting from a default.

4. Customer priority rule: Rules and procedures regarding priority of customer accounts over proprietary accounts of defaulting members or participants and, where applicable, in the context of specialized margin reduction programs such as cross-margining or trading links with other exchanges.

Core Principle 7—Rule Enforcement. Have arrangements and resources for the effective monitoring and enforcement of compliance with its rules and, as applicable, for resolution of disputes.

In addressing core principle 7, applicants may describe or otherwise document:

1. Surveillance: Arrangements and resources for the effective monitoring of compliance with rules relating to clearing practices and financial surveillance.

2. Enforcement: Arrangements and resources for effective enforcement of rules and authority and ability to discipline and limit or suspend a member's or participant's activities pursuant to clear and fair standards.

3. Dispute resolution: Where applicable, arrangements and resources for resolution of disputes between customers and members, and between members.

Core Principle 8—System Safeguards. Have a program of testing, oversight and risk analysis to ensure that its automated systems function properly and have adequate capacity, security, emergency, and disaster recovery procedures.

In addressing core principle 8, applicants may describe or otherwise document:

1. Oversight/risk analysis program:

a. Whether a program addresses appropriate principles for the oversight of automated systems to ensure that its clearing systems function properly and have adequate capacity and security;

b. Emergency procedures and a plan for disaster recovery; and

c. Periodic testing of back-up facilities and ability to provide timely processing, clearing, and settlement of transactions.

2. Appropriate periodic objective system reviews/testing:

a. Any program for the periodic objective testing and review of the system, including tests conducted and results; and

b. Confirmation that such testing and review would be performed or assessed by a qualified independent professional. A professional that is a certified member of the Information Systems Audit and Control Association experienced in the industry is an example of an acceptable party to carry out such testing and review.

Core Principle 9—Governance. Have appropriate fitness standards for owners or operators with greater than ten percent interest or an affiliate of such an owner, and for members of the governing board, and a means to address conflicts of interest in making decisions.

In addressing core principle 9, applicants may describe or otherwise document:

1. Standards for fitness for clearing organization owners, operators, affiliates of owners or operators, and members of the governing board based on disqualification standards under section 8a(2) of the Act and a history of serious disciplinary offenses, such as those which would be disqualifying under § 1.63 of this chapter.

2. Collection and verification of information supporting compliance with standards: Verification information could be registration information or certification of fitness or affidavit of fitness by outside counsel based on other verified information.

3. Methods to ascertain presence of conflicts of interest and methods of making decisions in that event.

4. A recognized clearing organization may not limit its liability or the liability of any of its officers, directors, employees, licensors, contractors and/or affiliates where such liability arises from such person's violation of the Act or Commission rules, fraud, or wanton or willful misconduct.

Core Principle 10—Reporting. Provide all information requested by the Commission for it to conduct its oversight function of the clearing organization's activities.

In addressing core principle 10, applicants may describe or otherwise document:

1. Information necessary for the Commission to perform its oversight activities of the recognized clearing organization's activities:

a. Information available to or generated by the clearing organization that will be made available to the Commission, upon request and/or as appropriate, to enable the Commission to perform properly its oversight function, including counterparties and their positions, stress test results, internal governance, legal proceedings, and other clearing activities;

b. The types of information which are not believed to be necessary to provide to the Commission and why; and

c. The information the organization intends to make routinely available to members/participants or the general public.

2. Provision of information:

a. The manner in which all relevant information will be provided to the Commission whether by electronic or other means; and

b. The manner in which any information will be made available to members/participants and/or the general public.

Core Principle 11—Recordkeeping. Keep full books and records of all activities relating to its business as a recognized clearing organization in a form and manner acceptable to the Commission for a period of five years, during the first two of which the books and records are readily available, and which shall be open to inspection by any representative of the Commission or the U.S. Department of Justice.

In addressing core principle 11, applicants may describe or otherwise document:

1. Maintenance of records related to the function of a clearing organization in a form and manner acceptable to the Commission:

a. The different activities related to the function of the clearing organization for which the organization intends to keep books or records; and

b. Any activity related to the function of a clearing organization for which the organization does not intend to keep books or records and why this is not viewed as necessary.

2. How the entity would satisfy the requirements of § 1.31 of this chapter including:

a. What ''full'' or ''complete'' would encompass with respect to each type of book or record that would be maintained;

b. How books or records would be compiled and maintained with respect to each type of activity for which such books or records would be kept;

c. Confirmation that books and records would be open to inspection by any representative of the Commission or of the U.S. Department of Justice;

d. How long books and records would be readily available and how they would be made readily available during the first two years; and

e. How long books and records would be maintained (and confirmation that, in any event, they would be maintained for at least five years).

Core Principle 12—Public Information. Publicly disclose information concerning the rules and operating procedures governing its clearing and settlement systems, including default procedures.

In addressing core principle 12, applicants may describe or otherwise document:

Disclosure of information regarding rules and operating procedures governing clearing and settlement systems:

a. Which rules and operating procedures governing clearing and settlement systems should be disclosed to the public, to whom they would be disclosed, and how they would be disclosed;

b. What other information would be available regarding the operation, purpose and effect of rules;

c. How member/participants may become familiar with such procedures before participating in operations; and

d. How member/participants will be informed of their specific rights and obligations preceding a default and upon a default, and of the specific rights, options and obligations of the clearing organization preceding and upon the participant's default.

Core Principle 13—Information Sharing. Participate in domestic and international information-sharing agreements as appropriate, and use information obtained from such agreements in carrying out the clearing organization's risk management program.

In addressing core principle 13, applicants may describe or otherwise document:

1. Applicable appropriate domestic and international information-sharing agreements and arrangements including the different types of domestic and international information-sharing arrangements, both formal and informal, which the clearing organization views as appropriate and applicable to its operations.

2. Using information obtained from information-sharing arrangements in carrying out risk management and surveillance programs:

a. How information obtained from any information-sharing arrangements would be used to further the objectives of the clearing organization's risk management program and any of its surveillance programs including financial surveillance and continuing eligibility of its members/participants;

b. How accurate information is expected to be obtained and the mechanisms or procedures which would make timely use and application of all information; and

c. The types of information expected to be shared and how that information would be shared.

Core Principle 14—Competition. Operate in a manner consistent with the public interest to be protected by the antitrust laws.

Pursuant to Core Principle 14, an entity seeking recognition as a recognized clearing organization may request the Commission consider under the provisions of section 15 of the Act any of the entity's rules or policies at the time of application for recognition or thereafter. The Commission intends to apply section 15 of the Act to its consideration of issues under this core principle in a manner consistent with that previously applied to contract markets.

Issued in Washington, D.C., this 21st day of November, 2000, by the Commission.

Jean A. Webb,

Secretary of the Commission.

[This statement will not appear in the Code of Federal Regulations.]

Concurrence of Commissioner Thomas J. Erickson Regarding Final Rules for a New Regulatory Framework for Clearing Organizations

I concur with the adoption of the final rules relating to clearing organizations. Increasingly, clearing is being de-coupled from the exchange. More electronic

exchanges are choosing to contract with new or existing clearing organizations for this aspect of traditional exchange activity. From what the Commission heard at the public hearing on the proposed framework, this trend is expected to continue and accelerate. Accordingly, this proposal represents a first step toward providing clearing organizations with the flexibility they will need to adapt to this new environment.

Nevertheless, I am sympathetic to the concerns of domestic clearing organizations regarding competition, jurisdiction and scope. Specifically, the final rule's treatment of securities clearinghouses, banks, bank affiliates, and foreign clearinghouses with regard to the requirements of Part 39 would appear to subject futures clearinghouses to a significant competitive disadvantage. The Commission's final rules justify this approach with little more than the observation that it is consistent with the ''unanimous recommendations of the President's Working Group.'' [1] Much more needs to be done so that one segment of the industry is not disproportionately affected and unfairly hamstrung by these regulations. Therefore, while I support the final rules to the extent they represent the Commission's willingness to meet the evolving marketplace with innovative approaches, I do so with the caveat that Part 39 will clearly need the Commission's full attention in order to ensure that the Commission is not picking winners and losers. At a minimum, since these reforms follow so closely the recommendations of the President's Working Group, I hope that the members of the PWG will respond swiftly to today's action by making parallel changes to their own regulatory schemes implementing the PWG's recommendations.

Date: November 20, 2000.

Thomas J. Erickson,

Commissioner.

[FR Doc. 00–30269 Filed 12–12–00; 8:45 am]

BILLING CODE 6351–01–P

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 35

RIN 3038–AB58

Exemption for Bilateral Transactions

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rules.

SUMMARY: The Commodity Futures Trading Commission (Commission or CFTC) is adopting final rules to clarify the operation of the current swaps exemption. In addition, in a companion notice of final rulemaking published in this edition of the **Federal Register**, the Commission is adopting rules that provide for the clearing of transactions under the revised exemption. The Commission, in other companion releases, also is adopting a new regulatory framework to apply to multilateral transaction execution facilities and to market intermediaries. This new framework establishes a number of new market categories, including a category of exempt multilateral transaction execution facility. Nothing in these releases, however, affects the continued vitality of the Commission's exemption for swaps transactions in effect before December 13, 2000, or any of its other existing exemptions, policy statements or interpretations.

EFFECTIVE DATE: February 12, 2001.

FOR FURTHER INFORMATION CONTACT: Paul M. Architzel, Chief Counsel, or Nancy E. Yanofsky, Assistant Chief Counsel, Division of Economic Analysis, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581. Telephone: (202) 418–5260. E-mail: *PArchitzel@cftc.gov* or *NYanofsky@cftc.gov*.

SUPPLEMENTARY INFORMATION:

I. The Proposed Rules

On June 22, 2000, the Commission published proposed amendments to its part 35 swaps exemption to expand and to clarify its operation, including the availability of clearing for these transactions.[1] These amendments were proposed in order to provide greater legal certainty to the over-the-counter (OTC) markets and to reduce systemic risk. The President's Working Group on Financial Markets (PWG) [2] and the chairmen of the Commission's Congressional oversight committees encouraged the Commission in this undertaking.

The Commission proposed the amendments to part 35 in light of the changes that have occurred in the OTC markets since the Commission adopted its Swaps Policy Statement in 1989, and its subsequent part 35 swaps exemption in 1993. In the intervening years, the OTC derivatives markets have experienced dramatic and sustained growth. During this period, OTC financial derivatives have developed into global markets having outstanding contracts with a total notional value of over $90 trillion.[3] OTC derivatives have transformed finance, increasing the range of financial products available for managing risk.

The Commission proposed making several changes to part 35. First, the Commission proposed deleting specific reference to ''swaps'' within the exemption itself. Instead, the rule would refer to a ''contract, agreement or transaction'' that meets the requisite exemptive conditions. Moreover, as suggested by the PWG Report, the Commission proposed to delete the requirement that exempt transactions not be fungible or standardized and to make clear that insofar as such exempt transactions may be cleared, creditworthiness of the counterparty is not a condition of the exemption. PWG Report at 17. In addition, the Commission proposed, through an exemption from the private right of action provision of section 22 of the Act, that transactions entered into in reliance on the part 35 swaps exemption would not be subject to a claim for rescission solely due to a violation of the exemption's requirements. See *id.* at 18.

In proposing the rules, the Commission affirmed the continuing vitality of the exemptive relief that it had previously granted to transactions in the OTC market, including the part 35 exemption, the Policy Statement Concerning Swap Transactions (54 FR 30694 (July 21, 1989)) (Swaps Policy Statement), the Statutory Interpretation Concerning Forward Transactions (55 FR 39188 (Sept. 25, 1990)) (Energy Interpretation), and the Exemption for Certain Contracts Involving Energy Products (58 FR 21286 (April 20, 1993)) (Energy Exemption). Moreover, in recognition of its continuing vitality and to assist the public in locating it, the Commission proposed publishing the Swaps Policy Statement as Appendix A to part 35.

II. Comments Received

The Commission received 31 comment letters on the proposed rulemaking.[4] The commenters included

[1] *See* Final Rules for a New Regulatory Framework for Clearing Organizations, p.12.

[1] 65 FR 39033 (June 22, 2000).

[2] Recognizing the importance of the OTC derivatives markets, the chairmen of the Senate and House Agriculture Committees requested that the PWG conduct a study of OTC derivatives markets. After studying the existing regulatory framework of OTC derivatives, recent innovations, and the potential for future developments, the PWG on November 9, 1999, reported to Congress its recommendations. See Over-the-Counter Derivatives Markets and the Commodity Exchange Act, Report of the President's Working Group on Financial Markets (PWG Report). The PWG Report focused on promoting innovation, competition, efficiency, and transparency in OTC derivatives markets and in reducing systemic risk.

[3] See Our Estimates of Global Size Market (visited Oct. 10, 2000), *http://www.swapsmonitor.com.*

[4] In addition to these 31, a significant number of letters commenting on aspects of the regulatory framework in companion notices were also submitted to the Commission. In this and three companion Notices of Final Rulemaking which are being published in this edition of the **Federal Register**, comment letters (CLs) are referenced by file number, letter number and page. Comments filed in response to the notice of proposed