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A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations; Rules Relating to Intermediaries of Commodity Interest Transactions; A New Regulatory Framework for Clearing Organizations; Exemption for Bilateral Transactions; Final Rules

COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 1, 5, 15, 36, 37, 38, 100, 170 and 180

RIN 3038–AB55

A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and 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 multilateral transaction execution facilities, to market intermediaries and to clearing organizations. This new framework constitutes a broad exemption under the authority of section 4(c) of the Commodity Exchange Act (Act or CEA) from many of the current rules applicable to designated contract markets. In addition, the new framework relies more heavily on disclosure rather than merit regulation. It establishes three new market categories, including the category of exempt multilateral transaction execution facility and two categories of Commission-recognized and regulated multilateral transaction execution facilities. In companion releases published in this edition of the **Federal Register**, the Commission also is adopting new rules for intermediaries and entities that clear derivative transactions. These final rules make fundamental and far-reaching changes to Federal regulation of commodity futures and option markets. However, nothing in these rules alters or diminishes the Commission's responsibility for overseeing and enforcing compliance by self-regulatory organizations, Commission registrants and market participants with the provisions of the Act.

The Commission in a companion release published in this edition of the **Federal Register** also is expanding and clarifying the operation of the current swaps exemption. Nothing in these releases, however, would affect the continued vitality of the Commission's exemption for swaps transactions under part 35 of its rules, or any of its other existing exemptions, policy statements or interpretations. Moreover, nothing in the final rules would affect the application of any statutory exclusion, including in particular, the applicability of the exclusion under section 2(a)(1)(A)(ii), known as ''the Treasury Amendment.''

EFFECTIVE DATE: February 12, 2001.

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SUPPLEMENTARY INFORMATION:

I. Background

A. Overview

The Commission, on June 22, 2000, proposed a new regulatory framework to apply to multilateral transaction execution facilities that trade contracts of sale of a commodity for future delivery or commodity options. 65 FR 38986. The Commission proposed this new framework to ''promote innovation, maintain U.S. competitiveness, and at the same time reduce systemic risk and protect customers.'' *Id.* The framework provides U.S. futures exchanges greater flexibility with which to respond to the competitive challenges brought about by new technologies.

Specifically, the framework proposed to replace the current ''one-size-fits-all'' regulation for futures markets with broad, flexible ''core principles,'' and to establish three regulatory tiers for markets: recognized futures exchanges (RFEs), derivatives transaction facilities (DTFs) and exempt multilateral transaction execution facilities (exempt MTEFs). The proposed core principles were tailored to match the degree and manner of regulation to the varying nature of the products and the participants permitted to trade on a facility.

In general, the framework proposed a lower level of regulatory oversight where access to an exchange or facility is restricted to eligible participants or commercial participants or where the nature of the underlying commodity poses a relatively low susceptibility to manipulation. This reflects the reduced need to monitor closely such markets. The Commission also proposed, however, that markets serving a price discovery function, irrespective of the product traded or market participants, provide a degree of price transparency. The proposed framework therefore balanced the public interests of market and price integrity, protection against manipulation and customer protection with the need to permit exchanges and other trading facilities to operate more flexibly in today's competitive environment. As noted in the Notice of Proposed Rulemaking, the President's Working Group on Financial Markets and the chairmen of the Commission's Congressional oversight committees encouraged the Commission to consider proposing such major revisions to the regulatory framework.[1] 65 FR at 38987.

B. The Proposed Rules

Under the proposed framework, current U.S. futures exchanges would be included automatically in the RFE category.[2] These exchanges would be permitted greater business flexibility through compliance with core principles rather than the prescriptive regulations now in place. In addition to achieving greater flexibility in their current operations, the exchanges, as a business choice, also could operate as a DTF or as an exempt MTEF, as appropriate.

The proposed DTF market would be subject to an intermediate level of regulation. DTFs, like RFEs, would be Commission-recognized markets. As proposed, DTFs would be geared either to mainly institutional traders or to only commercial traders. Specific requirements proposed for DTFs differ somewhat depending upon whether a DTF is an institutional or a commercial market.

The Commission proposed that institutional-participant DTFs may provide a trading platform for transactions involving those commodities listed in the rules that are eligible for such an intermediate level of regulation.[3] Additional commodities,

[1] Recognizing the importance of the OTC derivatives markets, the Chairmen of the Senate and House Agriculture Committees asked the President's Working Group on Financial Markets (PWG) to conduct a study of OTC derivatives markets. After studying the existing regulatory framework for 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. The PWG report focused on promoting innovation, competition, efficiency, and transparency in OTC derivatives markets and in reducing systemic risk. Although specific recommendations about the regulatory structure applicable to exchange-traded futures were beyond the scope of its report, the PWG suggested that the Commission review existing regulatory structures (particularly those applicable to markets for financial futures) to determine whether they were appropriately tailored to serve valid regulatory goals.

[2] Products subject to the special procedural provisions of section 2(a)(1)(B)(ii) of the Act, however, must continue to be designated and regulated by the Commission as contract markets.

[3] The eligible commodities are those that are listed as eligible for trading on an exempt MTEF.

including agricultural commodities, would be eligible to trade on an institutional-participant DTF on a case-by-case determination. The Commission would make that determination based upon the depth and liquidity of the cash market and on the surveillance history of the commodity based on its actual trading history.

Although institutional-participant DTFs would be intended primarily for institutional traders, the proposed rules provide individual DTFs with the flexibility to decide whether or not to permit access by non-institutional traders. The Commission proposed, therefore, to permit access to a DTF by non-institutional traders only through a registered futures commission merchant (FCM) that is a member of a recognized clearing organization and that has $20 million of adjusted net capital. Those FCMs would be required to provide their non-institutional customers trading on a DTF with additional disclosures and other protections.

In addition, the rules proposed an intermediate level of oversight for commercial-participant DTFs. Only commercial participants trading for their own accounts would have access to these facilities. Commercial-participant DTFs may trade any commodity other than the agricultural commodities enumerated in section 1a(3) of the Act, government securities and commodities subject to the provisions of section 2(a)(1)(B)(ii) of the Act. Such commercial traders generally would have both the financial ability and the physical means to deliver tangible commodities or otherwise be involved in trading that commodity in connection with their line of commerce. Accordingly, certain requirements that were proposed to apply to institutional-participant DTFs would not be applicable to commercial-participant DTFs.

The Commission also proposed a market tier exempt from all Commission regulation, subject only to the Act's anti-fraud and anti-manipulation provisions and a requirement that, if performing a price discovery function, the market provide pricing information to the public. This exemption was proposed for facilities on which transactions would be entered into among institutional traders in contracts based upon a specified list of commodities.[4] The Commission proposed to exempt counterparties to such transactions from a claim in a private right of action that a violation of the terms of the exemption renders the transactions void. These exempt markets could not hold themselves out as being regulated by the Commission. As noted above, existing futures markets, where appropriate, would have the opportunity to operate under the terms of this exemption, if they so choose.

C. Overview of Comments

The Commission received a total of 71 comments from a wide range of commenters on the proposed new regulatory framework for multilateral transaction execution facilities.[5] The commenters included 24 trade associations, six commodity exchanges, two government agencies, four financial institutions, three attorneys, two institutional study organizations, one agri-business firm, a self-regulatory organization, and several energy and communication firms or markets.

In addition to comment letters, the Commission received oral and written statements during a public meeting held at the Commission's headquarters on June 27 and 28, 2000. At that meeting, members of the public had an opportunity to address the Commission and to respond to questions.[6] During the meeting, several panels of industry experts, representing the U.S. futures exchanges, the over-the-counter derivatives markets, emerging information and technology providers, market intermediaries and clearing organizations discussed the proposals in the context of current market structures and future trends. The proposed rules were also discussed and public comments received at a July 19, 2000, meeting of the Commission's Agricultural Advisory Committee (AAC).[7]

The overwhelming majority of the comments expressed general support for the Commission's proposed framework, and provided specific suggestions for its improvement. Many commenters described the Commission's initiative as a bold or important departure from the status quo which recognizes the beginnings of a new financial market landscape. In general, the commenters supported the framework's innovative concepts of providing greater regulatory flexibility by substituting core principles for prescriptive, one-size-fits-all regulations, and of tiered regulations tailored to the particular nature of the market. They also generally supported the Commission's initiative as providing greater legal certainty to various types of instruments.

Four commenters, however, strongly disagreed with the Commission's approach, albeit for opposing reasons. One institutional study organization argued that the proposal would take regulatory reform too far. In contrast, a second institutional study organization, an investment banking firm and an attorney expressed serious reservations, contending that the framework provided neither significant regulatory relief nor greater legal certainty. The substance of individual comments is discussed in greater detail below.

II. Final Rules

A. Exempt Multilateral Transaction Execution Facilities (Exempt MTEFs)

As discussed above, the Commission, in revised part 36, proposed a new, self-effectuating exemption for those multilateral transaction facilities (MTEFs) to which only eligible participants have access, either trading for their own account or through another eligible participant, and only for contracts based upon: (1) A debt obligation; (2) a foreign currency; (3) an interest rate; (4) an exempt security or index thereof, as provided in section 2(a)(1)(B)(v) of the Act; (5) a measure of credit risk or quality, including instruments known as ''total return swaps,'' ''credit swaps'' or ''spread swaps''; (6) an occurrence or contingency beyond the control of the counterparties to the transaction; or (7) cash-settled, based upon an economic or commercial index or measure beyond the control of the counterparties to the transaction and not based upon prices derived from trading in a directly

The rules relating to exempt MTEFs are discussed below. A market that otherwise might be eligible to be exempt from regulation as an exempt MTEF may voluntarily become a DTF in order to be become a ''recognized'' market.

[4] The proposed list of commodities included: a debt obligation, a foreign currency, an interest rate, an exempt security, a measure of credit risk or quality, or cash-settled based upon an economic or commercial index or based upon an occurrence or contingency.

[5] A significant number of letters commenting on aspects of the regulatory framework raised 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 (CL) are referenced by file number, letter number and page. Comments filed in response to the notice of proposed rulemaking on MTEFs, parts 36–38, are contained in file No. 21, on the notice of proposed rulemaking on intermediaries in file No. 22, on the notice of proposed rulemaking on clearing in file No. 23 and on the notice of proposed rulemaking on the part 35 exemption in file No. 24. These letters are available through the Commission internet web site, www.cftc.gov.

[6] A transcript of the proceedings was included in the Commission's comment file and is available through the Commission's internet web site.

[7] A transcript of the AAC meeting is also included in the Commission's comment file and is available on the Commission's website.

corresponding underlying cash market.[8] The Commission proposal was based upon the ''view that these commodities, when traded between or among eligible participants need not be subject to the regulatory scheme of the Act. Accord PWG Report at 17.'' 65 FR at 38988.

Many commenters strongly supported this new exemption. For example, the International Swaps and Derivatives Association, Inc. (ISDA) observed that the ''clarifications contained in the Exempt MTEF proposal are of critical importance to ISDA and its members.'' CL 21–37 at 4. Reuters Group PLC (Reuters), a provider and developer of ''electronic business-to-business transaction communities,'' stated that in its view, ''[t]his new category of Exempt MTEF provides significant legal certainty to new electronic marketplaces in the enumerated derivatives.'' CL 21–62 at 3. A group of commercial and investment banks (Coalition)[9] commented that it ''strongly supports the Commission's proposal, and believes that the proposal represents a very important initiative both to promote legal certainty and to facilitate the development by U.S. market participants of electronic trading systems and technologies and the expanded use of clearing facilities. In addition, proposed part 36 would * * * limit[] the ability of an eligible participant to repudiate unprofitable contracts based on the CEA. The Coalition strongly supports these provisions. * * *'' CL 21–65 at 9. An attorney with the firm of Covington & Burling commented that:

> Derivative transactions satisfying these three conditions would be exempt from virtually all CEA regulation * * * and *either* (1) *were* traded on a multilateral transaction execution facility (MTEF), under newly-proposed part 36 of the Commission's regulations; *or* (2) *were not* traded on an MTEF, under newly-revised part 35 of the Commission's regulations. Thus, participants * * * would obtain legal certainty about the limited scope of CEA regulation regardless of whether the means for executing transactions did or did not satisfy the technical definition of an MTEF.
>
> It is our understanding that several comments have been filed with the Commission that seek changes to the proposed regulations in ways that conceivably could affect the legal certainty described above, including the Commission's statement supporting such legal certainty. We urge the Commission not to make any changes that would affect the interrelationship between the MTEF exemption and the bilateral transactions exemption in a manner that would diminish the legal certainty provided to eligible participants trading exempt commodities.

CL 21–63 at 2–3.

A number of the comments that generally supported proposed part 36 also suggested specific modifications, relating mainly to the commodities which were proposed to be eligible for the part 36 exemption and the proposed definition of MTEF. These issues, along with three comments opposing the proposed part 36 exemption on mainly jurisdictional grounds, are discussed below.

1. Jurisdictional Issues

Three commenters objected to the part 36 exemption on jurisdictional grounds. *See,* CLs 21–28, 55 and 57. One of the three, JP Morgan Securities, Inc. (JP Morgan), objected generally to proposed part 36, and particularly to the inclusion of instruments eligible for the exemption that are ''a measure of credit risk or quality, including instruments known as 'total return swaps,' 'credit swaps,' or 'credit spread swaps,''' reasoning that:

> An Exempt MTEF is to be subject to the anti-fraud and anti-manipulation provisions of the Act, as well as to whatever future rule the Commission may enact governing information dissemination. Therefore, a proposed ''exemption'' from the CEA has the effect of extending the Commission's authority to facilities that may trade products, such as swaps, which are not the Commission's to regulate under the terms of the Act itself. A self-effectuating ''exemption'' in this instance unintentionally becomes the reverse, an assertion of CFTC jurisdiction over non-futures products.

CL 21–55 at 4.

However, JP Morgan's conclusion is erroneous. As explained in its Notice of Proposed Rulemaking (65 FR at 38989), and reiterated herein, the Commission, by providing an exemption under part 36, is not thereby making an initial determination that any particular instrument which may be trading in reliance on the exemption is or is not within the Commission's jurisdiction. The use of the Commission's section 4(c) exemptive authority in this context to provide legal certainty to novel instruments without a preliminary determination by the Commission of complex jurisdictional issues is precisely as intended by the Congress. When Congress adopted section 4(c) in 1992, the Conferees stated:

> The conferees do not intend that the exercise of exemptive authority by the Commission [under Section 4(c)] would require any determination beforehand that the agreement, instrument, or transaction for which an exemption is sought is subject to the Act. Rather, this provision provides flexibility for the Commission to provide legal certainty to novel instruments where the determination as to jurisdiction is not straightforward.[10]

Moreover, the assertion that the Commission through this exemption would extend provisions of the Act to instruments or persons not subject to the Act misconstrues the nature and the scope of the exemption. As proposed, rule 36.3(a) provides that the anti-fraud and anti-manipulation sections of the Act ''continue to apply to transactions and persons otherwise subject to those provisions.''[11] 65 FR at 38999. Thus, it is clear that the proposed rules do not attempt to extend application of the Act to any transactions not already subject to the Act.[12]

Proposed rule 36.2(g) requires that an exempt MTEF disseminate trading volume, price ranges and other trading data, but only pursuant to a Commission determination, after notice and an opportunity for a hearing, that the facility serves as a significant source for the discovery of prices. That procedure provides the facility with an opportunity to challenge the validity of the Commission's authority to issue and enforce such an order on the grounds that the instruments being traded are not subject to the Act.[13] Nevertheless, the Regulatory Studies Program of the Mercatus Center (Mercatus) opined that, even though ''a party could contest the CFTC's assertion of jurisdiction * * * it is the mere assertion of regulatory jurisdiction by the CFTC that in the past has created the legal uncertainties that these Proposals attempt to address.'' CL 21–57 at 4.

However, proposed rule 36.3(b), the contract non-repudiation provision,

[8] It should be noted that the instruments eligible for exemption are limited by operation of section 2(a)(1)(B) of the Act, which is reserved in proposed § 36.3(a). As the Commission observed, ''[t]he reservation, and application, of this provision is consistent with the language of section 4(c) of the act which limits the Commission's authority to exempt transactions from the application of section 2(a)(1)(B) of the Act.'' 65 FR at 38988.

[9] They are: Chase Manhattan Bank; Citigroup, Inc.; Credit Suisse First Boston, Inc.; Goldman Sachs & Co.; Merrill Lynch & Co., Inc.; and Morgan Stanley Dean Witter & Co.

[10] H.R. Rep. No. 978, 102d Cong., 2d Sess. 82–83 (1992).

[11] *See also,* CL 21–57 at 4, which makes the same fundamental error.

[12] In this regard, it must be noted that sections 6(c) and 9(a)(2) of the Act prohibit manipulation of ''the market price of any commodity, in interstate commerce,'' and is not limited in application to ''contracts of sale of a commodity for future delivery.''

[13] For example, were the Chicago Mercantile Exchange (CME) to offer trading of its Eurodollar contract through an exempt MTEF, the rule provides for public notice and an opportunity for public comment in determining that the market ''serves as a significant source for the discovery of prices for an underlying commodity'' and to require that, as a consequence, it disseminate certain information to the public. *See,* PWG Report at 19.

further removes any such potential negative, collateral effects on other markets. To the extent that part 36 applies to transactions traded on a facility, the contract non-repudiation provision also applies, reinforcing the legal certainty and validity of the transactions. On the other hand, to the extent that transactions and a market are outside of the Commission's jurisdiction, the Act and Commission rules (including the part 36 exemption) are inapplicable, and hence there can be no legal uncertainty about the validity of the contracts arising from the Act or Commission rules thereunder. As the Commission explained in the Notice of Proposed Rulemaking,

> the Commission is not making a determination that any market that is eligible to be an exempt MTEF under the proposed exemption is or is not subject to the Commission's jurisdiction under the CEA. Moreover, the fact that one market may operate as an exempt MTEF in reliance upon the proposed exemption * * * does not imply that the Commission has made a determination that any firm or entity that operates in a similar manner is subject to the Commission's jurisdiction under the CEA.

65 FR at 38989 (footnote omitted). Thus, the existence and application to any particular market of the part 36 exemption carries no negative legal inference or uncertainty for any other market.

Nevertheless, Mercatus further argues that the proposed exemption ''raises a whole new area for legal uncertainty in that the broad definition of MTEF in Proposed Rule 36.1(b) would appear to cover auction markets such as eBay and all other forms of B2B trading facilities, whether electronic or not.'' CL 21–57 at 5. Similarly, an attorney with the firm of Vinson & Elkins argues that, ''multilateral transaction execution facilities—regardless of the nature of their participants or the nature of the economic activity being undertaken on those facilities—must agree to become regulated by the CFTC.'' CL 21–28 at 1. This misconstrues the operation and structure of the part 36 exemption. As noted above, the exemption in part 36 is from application of the Act. To the extent that the Act does not apply to a facility's transactions, the regulatory framework is simply inapplicable. Thus, so long as a facility auctions instruments outside of the Commission's regulatory jurisdiction under the Act, these exemptions therefrom and this framework would have no application to its business.

2. Eligible Commodities

Some commenters have suggested that the commodities eligible for this exemption should differ somewhat from those proposed by the Commission. Specifically, the United States Department of the Treasury (Treasury) recommended that government securities should be ineligible for trading on exempt MTEFs. Treasury noted that contracts eligible to trade on an exempt MTEF would have included both single government securities and baskets of government securities. It further noted that ''[s]ince the introduction of futures contracts on government securities in the late 1970s, the trading of these instruments on futures exchanges has always been subject to Commission regulation, and all dealers and brokers in the cash market for government securities have been subject to regulation since the enactment of the Government Securities Act.'' CL 21–50 at 2.

As the Commission explained in its Notice of Proposed Rulemaking, 65 FR at 38988, its determination of which commodities to include as eligible for exempt MTEF status was informed by the recommendations of the PWG, including its recommendation to exclude from the Act transactions by eligible participants on electronic trading systems in commodities other than non-financial commodities with finite supplies. Treasury, however, has concluded that, for futures and options on government securities, a higher level of regulation than trading as an exempt MTEF is necessary and appropriate in order not to ''undermine the integrity of the government securities markets.'' *Id.* As Treasury noted in its comment letter,

> [p]rior to 1986, * * * problems with these entities [government securities brokers and dealers] led to the passage of the Government Securities Act of 1986, which was amended in 1993 to address issues related to auction irregularities, short squeezes, and unfair sales practices * * *. Allowing government securities futures to trade on exempt MTEFs, where they would not be subject to the Government Securities Act or any other regulatory framework designed to address potential problems, could undermine the integrity of the government securities markets.
>
> [T]here have been a number of attempts to manipulate individual securities within the broader market. Additionally, fraud and mistreatment of customers has in the past also been a concern in the government securities market.

Id.

In deference to Treasury's expressed concern that a higher level of regulation is necessary than provided at the exempt MTEF level, the final rules adopted by the Commission do not include government securities as eligible for trading on exempt MTEFs. 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.

In contrast to Treasury's recommendation to delete government securities from the list of eligible commodities, several commenters with energy-related businesses suggested that energy-related products be added to the list of commodities eligible to trade on exempt MTEFs. *See* CLs 21–34, 37, 38, 43. Merrill Lynch Co., Inc. (Merrill Lynch), for example, opined that ''over-the-counter bilateral trading in energy products between commercial entities has been exempted * * * since 1993 * * * and that no pattern of abuses or irregularities has been identified.'' CL 21–38 at 9. It further reasoned that, ''electricity trading remains subject to oversight by the FERC and the states, including licensing standards for market participants, reporting requirements, and enforcement authority to remedy any problems that may arise.'' *Id.* at 12. Merrill Lynch also noted that action has been taken by the FERC,

> to promote open access to transmission grids for natural gas. * * * Similarly, many state legislatures and public utility commissions * * * have adopt[ed] rules to facilitate or require the unbundling of gas distribution from production and supply. [A] standardized form of contract is in widespread use in the natural gas market. Given this statutory background, it would be inconsistent with the intent of Congress and actions taken by the FERC for the Commission to impose additional regulation on natural gas trading.

Id. at 13.

However, the Commission does not require that cash markets, such as those described above, come within the regulatory framework.[14] Centralized markets to trade spot and forward agricultural commodities have long existed outside of the regulatory scheme that applies to futures and option markets. The Act, and the regulatory framework thereunder, apply to markets that trade futures or option contracts on such underlying commodities. Accordingly, there is no inconsistency between the Commission's regulation of futures markets and regulation of the underlying cash markets by other regulators, such as the FERC or the states. To the contrary, the Commission in its oversight of the futures and option

[14] *See*, CFTC Staff Letter No. 99–67, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,970 (Dec. 16, 1999), relating to a market established by the legislature of California for the trading of electricity.

markets coordinates and cooperates with the regulators of related underlying cash markets.

Moreover, although some commenters expressed the view that energy products under the regulatory framework should be eligible to trade on exempt MTEFs based on the sophistication of traders in the market,[15] eligibility for exempt MTEF treatment must also be premised upon a finding that the likelihood of manipulation is sufficiently low that regulation is not required. That case has not yet been made. Existing derivative contracts involving energy commodities typically are based on physical delivery within a relatively narrow geographic area. Delivery under these contracts can be subject to physical constraints, *e.g.*, pipeline congestion, transmission congestion in the case of electricity, weather or natural disaster related events, concentration of ownership of transmission, pipeline or storage and production capacity. Although the total supplies of a broadly defined energy commodity may be large if viewed on a global basis, only a small subset of that total supply typically would be available for delivery on a derivatives contract. As the New York Mercantile Exchange (NYMEX) pointed out in its comment,

> [t]he President's Working Group drew a distinction in its report that limited exclusion from CFTC regulatory authority to financial derivatives. The Working Group's reasoning, in part, was that financial derivatives had ''virtually inexhaustible supplies'' and that dealers in the swaps markets, * * * were subject to other forms of regulatory oversight. That is not the case with many participants in the OTC energy derivative marketplace. Because the President's Working Group focused primarily upon financial derivatives in its report, one may reasonably conclude at this time that the case has yet to be made that such wholesale exemption from CFTC regulation for energy derivatives would serve the public interest.

CL 21–47 at 3. In agreement, Williams Energy Marketing and Trading Company, a company engaged in energy marketing and trading and risk management activities, noted that it ''supports the Commission's proposal to exempt from regulation those * * * MTEFs meeting the conditions specified in the proposed rule,'' and it urged the ''Commission to stay the course of establishing the basic parameters for its new regulatory framework.'' CL 21–25 at 3, 4.

As proposed, the final rules do not make energy-related commodities eligible for trading on exempt MTEF markets at this time.[16] The Commission is making this determination based upon its surveillance experience of designated contract markets on energy-related products and upon careful consideration of the comments. In making this determination, the Commission is not foreclosing generally any subsequent reconsideration of the issue. Moreover, the Commission proposed to permit individual markets, including those offering energy-related products, to petition the Commission for exemption under the provisions of part 36. As proposed, rule 36.2(h) specifically provides that ''any person or entity may apply to the Commission for exemption for other arrangements or facilities, on such terms and conditions as the Commission deems appropriate, including but not limited to, the applicability of other regulatory regimes.'' 65 FR at 38999. The New York Independent System Operator (NYISO) in its comment supported inclusion of this provision, stating that,

> [i]rrespective of whether the automatic exemption criteria are modified, NYISO supports the inclusion of a provision permitting the Commission authority to grant individual petitions for Exempt MTEF status * * *. This type of flexibility is, we believe, necessary to accommodate markets with which the Commission may not as yet be familiar as well as changing markets.

CL 21–61 at 7.

The Commission agrees that flexibility to address new and changing markets is both necessary and appropriate and is adopting proposed rule 36.2(h) as final.[17] As with other such general exemptive provisions, the rule does not limit the grounds on which such an exemption may be granted. *Compare*, 17 CFR 32.4(b) and 35.2(d). However, those petitioning for exemption should be guided by the overall principles underlying the framework, that

> the level of oversight applied to exchanges or trading facilities * * * be based on the nature of participants allowed to trade on the facility and certain characteristics of the commodities being traded. In general, where access to an exchange or facility is restricted to more sophisticated traders or commercial participants, or where the nature of the commodity being traded poses a relatively low susceptibility to manipulation, regulatory oversight would be set at a lower level, reflecting the reduced need to monitor closely such markets.

65 FR at 38988. The commodities that are eligible for exempt MTEF status enjoy nearly inexhaustible deliverable supplies or are otherwise not subject to limitation. Petitions for inclusion of additional commodities should be for commodities of a similar nature. In addition, petitioners should consider addressing the sufficiency and applicability of other regulatory schemes.

Proposed rule 36.2(b)(5) would make eligible for exemption contracts, agreements or transactions which are ''a measure of credit risk or quality, including instruments known as 'total return swaps,' 'credit swaps,' or 'spread swaps.' '' JP Morgan objected to their proposed eligibility on the grounds that:

> [t]he named swaps are commonly based upon the price of corporate equities or, in the case of credit swaps, corporate debt, which is represented by a non-exempt security. The Commission is given authority under 4(c) to exempt futures contracts. But if these particular swaps are futures, they cannot be exempted because they would run afoul of the Shad-Johnson Accord, which bans futures on non-exempt securities prices (except for indexes which have cleared a lengthy regulatory approval process). The part 36 exemption will be of no use because it specifically does not exempt such transactions from the Shad-Johnson Accord. So if the Commission has authority to exempt these transactions (which would only be the case if they are futures), it cannot do so (because the Shad-Johnson Accord prohibits such futures).

CL 21–55 at 4.

However, ''total return swaps,'' include a greater variety of instruments than just swaps on corporate equities or debt, which as JP Morgan correctly recognizes, are not exempt under part 36. Proposed rule 36.2(b) also includes instruments that are not the subject of the prohibitions of the Shad-Johnson Accord.[18] Specifically, for example,

[15] *See*, comment letter from the California Power Exchange, an exchange offering physical delivery cash forward markets for the purchase and sale of electricity between commercial parties. CL 21–34 at 3.

[16] Of course, the framework does not preclude the trading of such contracts altogether. Under the framework, contracts for these commodities may trade on an institutional-participant DTF based on a case-by-case determination by the Commission, on a commercial-participant DTF or on an RFE.

[17] ISDA suggests including a ''category of eligible commodities * * * that over time become traded in sufficient volume so as to be highly unlikely to be susceptible to manipulation.'' CL 21–37 at 4. The Commission is of the view that the petition procedure provided in part 36 would in fact provide it with the type of flexibility to respond to market developments that ISDA advocates. The Coalition recommended that this authority be delegated by the Commission to the Director of the Division of Economic Analysis. CL 21–65 at 10. The Commission is of the view that these determinations should not be delegated at this time.

[18] Moreover, the specific named types of instruments such as ''total return swaps'' in the clause beginning with the word ''including'' modify the more general description ''a measure of credit risk or quality.'' Thus ''total return swaps,'' a term which may include many different types of instruments, are included under this prong of the exemption only insofar as they are also ''a measure of credit risk or quality.'' Of course, as noted in the Notice of proposed Rulemaking and reiterated above, nothing in these rules would affect the

''total return swap'' also describes an agreement whereby one party agrees to pay the total return on a loan portfolio to its counterparty in exchange for semi-annual payments based on a floating interest rate. It is this type of contract, transaction or agreement, traded among eligible participants, that is exempt under rule 36.2(b)(5), which the Commission is adopting as proposed.[19]

Proposed rule 36.2(b)(7) provides that cash-settled contracts on any economic or commercial index or measure beyond the control of the counterparties and not based upon prices derived from trading in a directly corresponding underlying cash market are eligible to trade on an exempt MTEF. The Board of Trade of the City of Chicago (CBT) suggested that proposed rule 36.2(b)(7) be modified so that it is not limited to economic or commercial indexes not based upon prices derived from trading in a directly corresponding cash market. It argued that the requirement that the index or measure be beyond the control of the counterparties is alone sufficient to protect against manipulation. CL 21–36 at 3. However, the Commission believes that both requirements must be met to qualify for the exemption. Basing the cash settlement price of a futures contract on prices derived from trading on an underlying cash market necessarily raises issues regarding the potential ability and incentives of traders in one market to affect pricing in the other market.[20] The Commission, by adopting the rule as proposed, intends to make eligible for this broad exemption only those MTEFs on which the contract's settlement price is objectively determined based upon prices that are ''an objective measurement of an economic or commercial index.'' 65 FR at 38989. As the Commission made clear, the exemption,

> is not intended to include contracts based upon a cash-settlement price determined through cash-market trading of any physical commodity or financial instrument. * * * Finally, included in this category are contracts based on an objectively determined index value or measure of an economic or commercial index reflecting broad characteristics of the economy as a whole, or portions thereof, or material segments of commercial activity.

Id. The Notice of Proposed Rulemaking noted that the consumer price index or the gross domestic product, insurance data, bankruptcy rates, real estate rental indexes, measures of physical production or sales amounts such as housing starts or auto sales or crop yields are examples of contracts falling within this category.[21]

3. Definition of MTEF

Several comments raised issues relating to the proposed definition of MTEF. The Commission proposed in rule 36.1(b) to define ''MTEF'' as ''an electronic or non-electronic market or similar facility through which persons, for their own accounts or for the accounts of others, enter into, agree to enter into or execute binding transactions by accepting bids or offers made by one person that are open to multiple persons conducting business through such market or similar facility.'' 65 FR at 38999. As explained in the Notice of Proposed Rulemaking,

> [t]he definition as proposed does not, and is not intended to, ''preclude participants from engaging in privately negotiated bilateral transactions, even where these participants use computer or other electronic facilities, such as ''broker screens,'' to communicate simultaneously with other participants so long as they do not use such systems to enter orders to execute transactions.'' Accordingly, the definition makes clear that it does not include facilities merely used as a means of communicating bids or offers nor does it include markets in which a single market maker offers to enter into bilateral transactions with multiple counterparties who may not transact with each other.

Id. at 38989 (citation omitted).

Several commenters recommended that the definition of MTEF exclude trading systems that include a credit screen. CL 21–21 at 6; CL 21–37 at 4. One commenter, DNI Holdings, reasoned that ''this credit emphasis has always been a characteristic of swaps transactions, but has never been a characteristic of the futures exchanges.'' CL 21–21 at 5–6. However, in a companion notice of final rulemaking published in this edition of the **Federal Register**, the Commission, consistent with the amendment of part 35 to permit bilateral contracts, transactions or agreements to be cleared, is deleting individualized creditworthiness determinations as a condition for meeting its part 35 exemption for bilateral transactions.

Moreover, as technology increases the availability of electronic credit screens or filters, their use has become common in both multilateral and bilateral environments. As NYMEX notes in commenting on a different provision, which applies to multilateral trading facilities,

> this provision would appear to be premised upon the notion that the credit checking and position limit functionality would reside only within the FCM's internal systems * * *. However, * * * certain trading systems, such as NYMEX's NYMEX ACCESS'' electronic trading system maintains the credit checking functionality as a component of the host computer. Clearing Members may enter inputs into the system to set specific limits per customer.

CL 21–47 at 8.

Finally, the exemptions in part 35 and part 36, when taken together, exempt derivative instruments from regulation under the Act whether or not they are traded on an MTEF if: (1) They are traded among or between eligible counterparties; (2) they are based on the underlying commodities, instruments or measures listed in part 36; and (3) they are, if cleared, cleared by an authorized clearing organization. As correctly observed in a comment referenced above, ''participants in transactions that satisfy these three conditions would obtain legal certainty about the limited scope of CEA regulation regardless of whether the means for executing transactions did or did not satisfy the technical definition of an MTEF.'' CL 21–63 at 2. In light of the availability of the same degree of exemptive relief under either part 35 or part 36 for the specified commodities, the deletion of creditworthiness as a condition for exemption under part 35, and the use of credit screens and filters in both bilateral and multilateral environments, the final rule does not include such an exclusion.

The CBT suggested that the exclusion from the proposed MTEF definition in rule 36.1(b)(3) for ''any facility on which only a single firm may participate as market maker and participants other than the market maker may not accept

continued applicability of any existing Commission exemptions, policy statements or interpretations to such ''total return swaps,'' or to any other instrument. Moreover, the non-repudiation provision of rule 35.3(c) that the Commission is adopting in a companion release would also apply to such instruments.

[19] The rule, as proposed, referenced ''spread swaps'' rather than ''credit spread swaps,'' which were referenced correctly in the preamble at page 38988. The final rule corrects this typographic error.

[20] This is in contrast to proposed 36.2(b)(6) which applies to ''an occurrence, extent of an occurrence or contingency beyond the control of the counterparties to the transaction.'' As the Commission explained, this category is intended to include contracts:

> based upon the outcome of a contingency, such as a recurring or nonrecurring event, a specific incident, a natural phenomenon or the unambiguous results of some other condition that gives rise to a hedgeable risk.

65 FR at 38989. The Commission does not anticipate that the settlement price of such contracts could be derived from trading in a directly related cash market and has therefore not included that as a criterion.

[21] The Commission provided specific examples for each category of commodities eligible to trade on an exempt MTEF under proposed rule 36.2(b). 65 FR at 38988–89. Except for exempt securities, which are being deleted from eligibility in the final rules, each of those examples is incorporated herein by reference.

bids or offers of other non-market maker participants'' should be deleted. It reasons that ''the Commission's approach could be read to allow a futures exchange * * * to decide to use a single market-maker or specialist system, like many securities exchanges, and avoid being considered to be an MTEF.'' CL 21–36 at 4. However, under the proposed exclusion there can be but one counterparty to all market participants. That is quite different from using one or more specialists in a multilateral trading setting. In that structure, the bids and offers of non-specialists are permitted to interact with each other. The Commission believes that this is a valid and logical distinction between bilateral and multilateral trading structures and is adopting the proposed language as final.

The CBT also questioned whether the definition of MTEF in proposed rule 36.1(b) would affect the Commission's view of the scope of the Treasury Amendment exclusion in section 2(a)(1)(A)(ii) of the Act. CL 21–36–4. As the Commission stated in the Notice of Proposed Rulemaking,

> the definition of MTEF in proposed § 36.1(b) applies only to those rules in which it is cited. It is not intended to modify, alter, amend or interpret any other provision of the Act or the Commission's rules. For example, the proposed § 36.1(b) definition of MTEF does not affect the meaning or application of the statutory term, ''board of trade.'' 7 U.S.C. 1a(1). Thus, the scope and application of the statutory exclusion in section 2(a)(1)(A)(ii) of the Act, popularly known as the ''Treasury Amendment,'' which depends in part on the meaning of ''board of trade,'' is in no way affected by the Commission's proposed adoption of a definition of MTEF under § 36.1(b) for purposes of the exemptions in part 35 and part 36 of its rules.

65 FR at 38989.[22]

Finally, commenters suggested a number of technical modifications to the rules. The CBT suggested that the Commission modify the final rules to clarify that it is the participant to whom notice is provided under proposed rule 36.2(f)(1) and that the separate trading location (or pit) required for trading on exempt MTEFs under proposed rule 36.2(f)(2) may nevertheless adjoin the location wherein Commission-recognized markets are traded. CL 21–36 at 5. The Commission agrees with these suggestions and is modifying the final rules accordingly. In addition, the Minneapolis Grain Exchange (MGE), CL 21–24 at 4, suggested that the Commission modify proposed rule 36.2(e)'s requirement that an exempt MTEF be legally separate from Commission-recognized markets. Upon further consideration of the issue, and based upon the fact that many of the exchanges historically overseen by the Commission have housed both designated contract markets and markets for trading spot or forward contracts without adverse consequence, the Commission is deleting that requirement from the final rules.

B. Derivatives Transaction Facilities.

The Commission also proposed a new exemptive category, ''Derivatives Transaction Facilities,'' which provides for an intermediate level of regulation. This intermediate level of regulation was proposed to be available for two separate types of markets. Although many of the proposed rules are common to both types of markets, some of the proposed rules were tailored to apply to one or the other market.

The first type of DTF proposed by the Commission was for (primarily) ''eligible-participants.''[23] Under the provisions of proposed part 37, these markets or similar facilities, including the current boards of trades, would be eligible to become a DTF regardless of the method of transmitting bids and offers or matching system used, either on a case-by-case determination or if the contracts traded were on the list of commodities eligible to trade as an exempt MTEF.[24] The Commission proposed that such ''eligible participant DTFs'' would have the choice of whether or not to permit access to the market by non-eligible traders. If they did permit access to non-eligible traders, a number of additional requirements were proposed to apply, including enhanced disclosure and higher net capital requirements for the carrying FCM.[25]

The Commission proposed a second type of DTF under proposed part 37 for facilities that restricted participation to ''eligible commercial participants.'' This type of ''commercial-participant DTF'' would be eligible to trade contracts on all commodities other than those domestic agricultural commodities enumerated in section 1a(3) of the Act,[26] any securities or indices thereof subject to section 2(a)(1)(B)(ii) of the Act or any exempt securities or indices thereof included in section 2(a)(1)(B)(v) of the Act. This type of eligible commercials-only market structure lessens many of the regulatory concerns regarding manipulation ordinarily present with contracts for tangible commodities and the regulations that are applicable to them have been tailored to this specific type of market.[27]

Although a few commenters objected to the DTF rules on jurisdictional grounds, many more commenters supported the concept of providing for an intermediate level of regulation. These commenters included both those interested in the eligible-participant DTF as well as those interested in the commercial-participant DTF. For example, Cargill stated that the ''three-tier system seems to provide adequate regulation for a wide range of financial products and market participants depending on the relative sophistication of the participants.'' CL 21–49 at 2. The Coalition stated that it supports the Commission's efforts to create an intermediate category of regulated trading facility subject to less regulation than an RFE and more regulation than an exempt MTEF. The Coalition went on to say that the tiered approach recognizes that there is a wide range of

[22] The CBT raises the concern whether the Act's Treasury Amendment exclusion would continue to apply to an exempt MTEF without an explicit reservation in the rules of that provision of the statute. CL 21–36 at 4. As the Commission explained in the Notice of Proposed Rulemaking and reiterated herein, ''the scope and application of the statutory exclusion in section 2(a)(1)(A)(ii) of the Act * * * is in no way affected'' by this regulatory exemption. Thus, the determination of whether or not a person or facility is a ''board of trade'' for purposes of the Act, generally, and the Treasury Amendment, specifically, should be made without reference to the definition of ''multilateral transaction execution facility'' under rule 36.1(b), which operates in the context of exemptions for markets to which access is limited to eligible participants.

[23] In a companion notice of final rulemaking published in this edition of the **Federal Register** entitled ''Rules Relating to Intermediaries of Commodity Interest Transactions,'' the term ''institutional customer'' is used rather than ''eligible participant.'' These terms can be used interchangeably.

[24] The Commission also expects, however, on a case-by-case basis, that the surveillance history and the self-regulatory undertakings of a particular exchange or facility could make it possible to include a specific contract traded on that facility within the DTF category even if the underlying commodity does not meet the general eligibility criteria. An exchange or facility seeking a case-by-case determination would be recognized as a DTF for that contract or contracts only upon CFTC approval.

[25] Amendments to the Commission's rules governing intermediaries are published today in a separate release in this edition of the **Federal Register**. Although those amendments apply to all categories of intermediaries irrespective of where they choose to transact business, certain proposals differentiate between intermediation on various types of markets and for different types of customers.

[26] They are wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, potatoes, wool, wool tops, fats and oils, cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice.

[27] Many of these trading facilities are expected to replicate electronically various aspects of today's commercial markets, including trading exclusively between principals, and direct negotiation and documentation of trades. In addition, these facilities often do not provide clearing arrangements for contracts.

types of markets, trading systems and market participants, and that it will facilitate market innovation. CL 21–65 at 16. The Association for Investment Management and Research (AIMR) opined that the tiered approach to regulation recognizes different operational profiles and risks inherent to individual participants. CL 21–64 at 3.

Commenters also suggested that the Commission reconsider various specific aspects of the rules as proposed. These suggestions clustered around how various commodities, including in particular, domestic agricultural commodities, should fit within the framework, how eligible participants should be defined, under what conditions non-eligible participants should have access, how the core principles should be enforced and what further tailoring might be appropriate for regulating commercial-participant DTFs. Each of these issues is discussed in greater detail below.

1. Jurisdictional Issues.

Although contracts, agreements or transactions traded on a DTF would be exempt from many of the Act's provisions and Commission regulations,[28] the exemption is contingent upon compliance with the conditions set forth in part 37. A market that applies to the Commission for recognition, and is so recognized by the Commission, is bound to comply with applicable provisions of the Act and Commission rules as a condition of this exemption.

Notwithstanding the requirement that a market or facility must apply to the Commission for recognition in order for the part 37 exemption to pertain, Mercatus questioned how commercial markets for physical commodities would be treated in this regime, and suggested that the Commission provide further guidance on the reach of the proposed part 37 in this area. CL 21–57 at 6. As the Commission noted in proposing part 37 (65 FR at 38989), and reiterates here, in exercising its section 4(c) exemptive authority to date, the Commission has not made a determination that the transactions being exempted were, or were not, subject to the Commission's jurisdiction under the CEA.[29] Rather, the Commission has exercised its section 4(c) authority to provide legal certainty for instruments that *may* be within its jurisdiction. However, the Commission will not entertain applications for recognition from markets or facilities offering transactions that clearly are outside of its jurisdiction.

The Coalition directly addressed this issue and supports the Commission's view. It reasoned that

> the Commission would not be authorized to exercise jurisdiction over activities that are clearly outside its jurisdiction under the CEA. Examples of this would include trading in equity options and spot transactions.
>
> At the same time, the conferees to the Futures Trading Practices Act of 1992 (the ''FTPA'') expressly authorized the Commission to exercise its exemptive authority under Section 4(c)(1) of the CEA without determining whether the exempted transactions are subject to the CEA. And they authorized the Commission to do so on such terms and conditions as the Commission deems appropriate. The conferees specifically so provided to enable the Commission to act without making consequential jurisdictional determinations that might create legal uncertainty for, or imply the illegality of, other transactions.
>
> For precisely the reasons motivating the FTPA conferees, the Coalition believes that the Commission is authorized to and should accept requests by trading facilities who wish to be registered as DTFs and who request that the Commission not make any determination that the underlying transactions are futures contracts or commodity options. The Coalition agrees with the Commission's implicit judgment that this approach will minimize the adverse jurisdictional implications, and therefore the legal uncertainty, that might otherwise arise if one trading facility elects to pursue DTF registration in circumstances where other, possibly analogous trading facilities do not. However, as suggested by the immediately preceding discussion, the Commission should only so proceed in cases where a bona fide issue as to its jurisdiction exists and should not so proceed in any case where it is clear that the Commission lacks jurisdiction.

CL 21–65 at 17–18.

As the Commission noted above with regard to the application of the part 36 exemption, this framework has no applicability to markets or facilities that clearly are outside of the scope of the Act and the Commission's jurisdiction. Thus, the availability of part 37 recognition to those markets that apply in no way carries a negative legal inference or uncertainty for any other market. Accordingly, the Commission is of the view that providing legal certainty through this part 37 exemptive relief to markets or facilities that may be subject to the Act is consistent with Congress' mandate to the Commission and is in the public interest.

2. Commodities

A number of commenters recommended that the framework be modified with regard to its application to the agricultural commodities enumerated in section 1a(3) of the Act. The Commission proposed that contracts on those commodities not be permitted to trade on a commercial-participant DTF, and that they be permitted to trade on an eligible-participant DTF only on a case-by-case determination by the Commission.

The response of commenters representing various agricultural interests was divided. National Grain and Feed Association (NGFA) argued that agricultural markets should be regulated in precisely the same manner as markets for financial commodities. The American Cotton Shippers (Cotton Shippers) argued that any differences in regulation of agricultural commodities penalizes these markets by denying them the benefit of potential marketing innovations. CL 21–12 at 3–5. MGE and the National Grain Trade Council (NGTC) also argued that there should be no distinction in the regulatory framework for the enumerated agricultural commodities. CL 21–24 at 1–2; CL 21–46. An FCM, F.C. Stone, contended that agribusiness firms have substantial risk management experience and can themselves weigh the risks of using a particular trading facility. CL 21–59 at 3.

A significant number of commenters favored permitting enumerated agricultural commodities to trade on an eligible-participant DTF on a case-by-case determination, as provided in the proposed rules. In a joint comment letter, eight agricultural producer groups[30] supported a case-by-case

[28] Certain sections of the Act, including the fraud and manipulation provisions of the Act and the Commission's regulations are reserved in rule 37.8 and would continue to apply.

[29] As noted above, the legislative history states that the Commission in exercising its section 4(c) exemptive authority is not required to make an initial determination that the agreement, instrument, or transaction for which an exemption is sought is subject to the Act. Accordingly, in carrying out this mandate, when the Commission exempted certain swap agreements in 1993, pursuant to section 4(c) of the Act, it stated:

> The issuance of this rule (Rule 35.2) should not be construed as reflecting any determination that the swap agreements covered by the terms hereof are subject to the Act, as the Commission has not made and is not obligated to make any such determination.

58 FR 5587, 5588 (Jan. 22, 1993). See also Order Granting the London Clearing House's Petition for an Exemption Pursuant to Section 4(c) of the Commodity Exchange Act, 64 FR 53346 (Oct. 1, 1999); Exemption for Certain Contracts Involving Energy Products, 58 FR 21286, 21288 (Apr. 20, 1993); Regulation of Hybrid Instruments, 58 FR 5580, 55821 n. 2 (Jan. 22, 1993). The Commission is following this same mandate with respect to this exemption for DTFs.

[30] The eight groups are: the American Farm Bureau Federation, American Soybean Association, National Association of Wheat Growers, National Cattlemen's Beef Association, National Corn Growers Association, National Farmers Union,

Continued

Commission determination of eligibility for DTF trading of individual agricultural commodities. They emphasized, however, that the Commission should provide notice and accept public comment as part of its deliberative process. They further cautioned that such a determination should include appropriate conditions in addition to the seven DTF core principles. CL 21–60 at 1. The NGTC concurred, suggesting that DTFs be permitted to trade agricultural commodities conditioned upon enhanced surveillance (RFE Core Principle 3), position limits (RFE Core Principle 4), and such other requirements that the Commission concludes are essential to market integrity. Cargill, while recognizing that certain agricultural commodities may be subject to manipulation, nevertheless recommended that the CFTC should retain flexibility to address this issue by spelling out criteria that would have to be met for such a commodity to achieve DTF status. CL 21–49 at 2–3.

The final rules, as proposed, provide that the Commission may determine on a case-by-case basis to permit any commodity, including the enumerated agricultural commodities, to trade on an eligible-participant DTF. The Commission remains convinced, as do many commenters, that this strikes the appropriate balance between caution and flexibility to respond to future developments. Moreover, the commenters' suggestions that any case-by-case determination include particular, tailored conditions to the general core principles are well-taken. In this regard, the Commission is of the view that, at a minimum, any DTF trading a commodity on a case-by-case basis will be required to retain the large trader reporting system that pertains to RFEs. The Commission will determine additional requirements, if any, during each individualized determination. In this regard, the procedures to be used by the Commission in such case-by-case determinations will indeed include public notice and an opportunity for public comment.[31]

Commission rule 37.2(a)(2)(i) provides that commodities eligible through a case-by-case determination to trade on a DTF ''have a sufficiently liquid and deep cash market and a surveillance history based on actual trading experience to provide assurance that the contract is highly unlikely to be manipulated.'' The Global TeleExchange (GTX) commented that the Commission should articulate the standards that it will use to judge whether there is a ''sufficiently liquid and deep cash market'' to warrant approving a contract for DTF trading. CL 21–40 at 4. The Commission is not establishing quantitative thresholds or criteria for DTF inclusion *a priori,* because the appropriate standards necessarily would differ across markets and time, and the adoption of specific, detailed standards would deny the Commission and applicants needed flexibility.[32]

In making a determination whether a contract is highly unlikely to be manipulated and thus eligible for DTF trading through an individualized determination, the Commission will consider both the liquidity and depth of the underlying cash market *and* the actual trading experience of the contract, including, where relevant, the facility's surveillance history in monitoring the market and in addressing market problems. Sufficient liquidity and depth of the underlying commodity can be demonstrated by looking at a number of specific factors. These include: (1) A high level of liquidity; (2) bid-ask spreads that are narrow relative to traded values; (3) relatively frequent transactions involving participants that represent major segments of the industry; (4) the absence of material impediments to participation by commercial entities; (5) transfer of ownership that is easily and readily accomplished at minimal cost; and (6) a pattern of pricing that exhibits continuity and the absence of frequent, sharp price changes such that a person cannot readily move materially the price of the product in normal cash market channels. Facilities seeking recognition as a DTF should provide to the Commission information on these factors. Actual trading experience acceptable for DTF eligibility can be based upon a history that the contract terms and conditions provide for a deliverable supply that is adequate to minimize the threat of market abuses such as price manipulation and distortions, congestion, and defaults,[33] and by having in place appropriate procedures effectively to oversee the market, including a large trader system, as well as a history of active surveillance to prevent or mitigate market problems.[34]

3. Access by Non-Eligible Participants

Only eligible participants (*i.e.,* institutional traders) would have unrestricted access to an eligible-participant DTF. Non-eligible participants may access the market, but only through a registered FCM with $20 million in net capital that is a clearing member of a contract market or RFE. *See,* rule 37.2(a)(2)(ii). A number of commenters opposed this requirement. The CBT contended that this requirement is overly burdensome and does not further the Commission's stated goal that DTF transactions ''be transacted through FCMs that are more capable of properly maintaining such accounts and handling the associated risk.'' CL 21–36 at 7. It further reasoned that net capital is a poor proxy for an FCM's trading capabilities or level of regulatory compliance and that the rule favored large FCMs at the expense of smaller FCMs. *Accord,* CL 21–24. The CME disagreed with the premise of the rule that transactions on a DTF entail a higher degree of financial risk than do transactions on an RFE, especially in the context of futures based on liquid financial instruments carrying little risk of manipulation. CL 21–51 at 8. NGTC also questioned the relationship between an FCM's capitalization and its fitness to handle retail accounts on a DTF and argued that the $20 million threshold requirement was inconsistent with other CFTC capital requirements. CL 21–46 at 4–6.

Although adjusted net capital may be an imprecise measure of an FCM's capability to service accounts, the Commission nevertheless believes that the capital requirement proposed to be required of FCMs who trade on DTFs for non-institutional customers is appropriate at this time. Because of the absence of restrictions on the type of

National Grain Sorghum Producers and National Pork Producers Council, and will be referred to hereafter as ''agricultural producer groups.''

[31] Treasury similarly commented with respect to whether government securities should be permitted to trade on a DTF. It recommended that continued application of the segregation of customer funds requirements, certain adjustments to capital requirements for FCMs executing trades for retail customers and large trader reporting be conditions of permitting government securities to trade on a DTF. The Commission will certainly consider these views if any such request to trade government securities on a DTF is received. Moreover, consistent with current practice under the Act, the Commission will continue to keep Treasury apprised of new contracts involving government securities to be listed on both DTFs and RFEs.

[32] GTX also added that, in its view, telecommunication minutes and other telecommunication products should qualify as such a market. The Commission is not making such a determination in this rulemaking. That decision is better made as an individualized determination where a factual record can be developed and public comment specifically sought on the issue.

[33] In this regard, deliverable supply represents the amount of the commodity meeting the contract's specifications at the delivery locations that is available for delivery at its economic value in normal cash marketing channels.

[34] This requirement is not intended to preclude a market experienced in the trading of only cash or other instruments from making the necessary demonstrations. Such facilities may rely on that market experience in making the necessary demonstration.

trading mechanisms that could be used by a DTF, and the possibility of a greater number of such competing markets trading similar products, filling non-institutional customer orders at the best price would likely require the FCM to have a more extensive and sophisticated infrastructure and greater trading resources than an FCM operating in a traditional setting. Accordingly, the Commission, at this time, is adopting the capital-related access restriction as proposed. The Commission will consider further appropriate measures to permit additional FCMs to handle non-institutional customers' access to DTFs as experience is gained under the rules.

The Managed Funds Association (MFA) argued that customers trading through registered CTAs should have trading access to DTFs without regard to their individual financial qualifications. In particular, MFA suggested that a CTA with at least $25 million under management should be permitted to engage in transactions on behalf of their clients on all eligible-participant DTFs. CL 21–31 at 5. Although the Commission is not prepared at this time to treat a CTA's customers as eligible participants without limitation on the basis of the CTA's management of the account, the Commission does recognize that CTAs provide expertise and professional management to their customers. In recognition of this role, the Commission is revising proposed rule 37.2(a)(2)(ii) to permit CTAs, with at least $25 million under management and having non-institutional clients, to access DTFs that permit non-institutional participants on behalf of both their institutional and non-institutional customers through accounts carried by *any* registered FCM. The Commission will reconsider this issue when it looks more broadly at revising current rules applicable to CTAs and commodity pool operators.

NYMEX expressed concern that the proposed requirement that non-eligible traders access a DTF through an FCM may not address adequately electronic systems with direct customer order entry on which FCM credit filters are resident. The Commission agrees, and is modifying 37.2(a)(2)(ii) to make it clear that while the accounts of non-eligible traders must be carried by registered FCMs, they may have direct trading access to the DTF if a credit filter is required to be used by the FCM, regardless of where the filter is resident.

4. Commercial-Participant DTF

The Commission proposed that an intermediate level of regulation also apply to commercial-participant DTFs. The proposed rules applicable to commercial-participant DTFs, although having common elements with eligible-participant DTFs, also have a number of special features. For example, the proposed core principles for DTFs may include two alternatives, with the proviso that they apply to the market ''as applicable.'' *See, e.g.,* Core Principle 2, rule 37.4(b). Only one of the alternatives may be appropriate for a particular facility, and should be understood to apply in that manner.

One commenter, a company beginning an electronic platform for trading ''physical commodities and derivative products * * * among commercial participants,'' opined that ''the overall approach * * * will result in the imposition of excessive and unwarranted burdens on Commercial DTFs.'' Intercontinental Exchange, LLC (Intercontinental) CL 21–22 at 2. A second letter from a group of oil and gas producers, refiners, processors, and marketers and electric utilities and marketers (Energy Group) raised many of the same issues as did Intercontinental. CL 21–23. Specifically, these letters suggested that the Commission provide for a streamlined review procedure for recognition of a DTF within a fixed time period. The letters further stated that the DTF may not have ''exchange-style memberships or rules. Any substantive review of commercial DTFs, their owners or operators, therefore, or any review of rules or principles applicable to trading on or through such facilities would be inappropriate and unwarranted and will render the DTF framework completely unworkable.'' CL 21–22 at 3. They also noted that electronic platforms may have ''trading protocols, product descriptions, fee schedules, user guides and similar trading or transaction related documents or information'' rather than trading rules. *Id.*

The proposed rules, however, recognized this distinction and provided that the facility have rules *or terms and conditions* governing trading procedures. *See, e.g.,* proposed rule 37.3(a)(2). The reference to ''terms and conditions'' was intended to apply to trading platforms that did not have exchange-style rules and instead incorporated their trading procedures as terms of their operating agreements. However, ''terms and conditions'' is already a defined term under Commission rule 1.41(a)(2). To provide greater clarity of the Commission's intent, the final rules refer to ''rules, which may be trading protocols.'' Trading protocols include the methods and conditions for trading that may be included in a user's guide or operator's manual, customer agreements, screen trading prompts or other similar documents or writings.[35]

Intercontinental also opined that the reservation of various sections of the Act in proposed rule 37.5(a) potentially would subject a DTF to a number of additional obligations beyond those included in the rules themselves. CL 21–22 at 4. The Commission's intent, however, in reserving various sections of the Act in part 37 was not to import additional regulatory obligations into the part 37 rules. Rather, its reservation of various sections of the Act is to establish legal authority for promulgating these regulatory requirements. By reserving these sections of the Act, the Commission does not intend to incorporate regulatory requirements for DTFs beyond those specified in part 37. Moreover, the Commission intends that the reserved sections of the Act be interpreted as applying to DTFs as the difference in the contexts require. Some of the Act's provisions, such as section 4c(a) of the Act are reserved ''as applicable,'' depending upon the particular characteristics of a trading facility. The Commission will confirm whether that section of the Act applies to a particular facility in its Order granting recognition to the facility.

In contrast to the reservation of provisions of the Act effectuating the regulatory conditions of the exemption, the Commission has deleted from the final rules in parts 37, 38, and 39 specific reservation of various enforcement provisions that it had proposed specifically to retain. The Commission has determined that such specific reservations are unnecessary. Rather, such specific reservations do not affect the Commission's existing authority to investigate violations and to bring enforcement actions. *See,* section 4(d) of the Act.

In order to conform the regulatory requirements of the commercial-participant DTF more closely to cash market practices, the Commission is deleting the proposed requirement that participants respond to special calls for information about their trading activities. The Commission will rely instead on its investigative authority, which also applies to a person's cash market activities. Moreover, the Commission is not requiring that a non-U.S. participant appoint an agent for receipt of service of process within the United States or that the DTF act in that

[35] In addition, the Commission is amending the definition of ''rules'' under Commission rule 1.41(a)(1) specifically to include the term ''trading protocols.''

capacity. Instead, the Commission is requiring that the commercial-participant DTF provide notice to its non-U.S. participants of communications from the Commission. In the event that a non-U.S. participant fails to comply with such a Commission communication, the Commission may direct recognized DTFs to deny the participant further trading access. *Compare,* 17 CFR 21.03. By modifying the final rules in this way, the Commission is bringing the rules for commercial-participant DTFs into closer alignment with the operation of related cash markets, and the requirements on participants on commercial-participant DTFs, by and large, will be no greater or no different than is applicable to cash market trading.

Finally, both comment letters suggested that the rules applicable to DTFs be located entirely within part 37 without cross-referencing other rules. The Commission has modified the final rules to reduce the number of cross-references within part 37. Accordingly, the final rules have been reorganized to include a new rule 37.5 relating to information requirements (formerly in proposed part 20) and has divided the requirements for recognition into two sections. These modifications to the final rules change the substance of the rules only as discussed above. A number of voluntary provisions remain as cross-references to other rules.

Several commenters raised issues regarding the proposed definition of ''eligible commercial participant.'' Both NYMEX and the Commodity Floor Brokers and Traders Association expressed concern that exchange locals were not included within the category of eligible commercial participants. They reasoned that locals provide the same market making function as do dealers, a category included within the definition of eligible commercial participant. NYMEX noted that professional floor traders provide approximately 43–49% of the trading volume in NYMEX energy contracts. CL 21–47 at 4. NYMEX further noted that unless floor traders were included, the commercial-participant DTF model would ''be used to exclude * * * another business model [exchanges] that is generally comparable but for the sharing of market making responsibilities among a group of professional market makers rather than concentration of this function in a single dealer.'' *Id.* at 10. The CBT concurred, stating that ''[c]ertainly floor brokers and floor traders that trade regularly on exchange markets should be considered to be as sophisticated as any market participants. For that reason, in the Commission's current part 36 rules, floor brokers and traders are defined to be eligible participants without regard to any total or net asset test.'' CL 21–36 at 6. The Commission agrees that Commission registrants, particularly floor brokers and floor traders should be included as eligible to trade in a DTF with a guarantee of their obligations by a futures commission merchant, as suggested by NYMEX.[36]

These rules establish an intermediate level of regulation for DTFs appropriate to the commodities traded and the participants trading thereon. DTFs have great flexibility in determining the trading systems and mechanisms that they will use. Accordingly, and in light of their institutional nature, participants trading on DTFs are expected to exercise the appropriate degree of understanding in making use of these facilities. Notwithstanding part 37's greater degree of regulatory flexibility, the Commission retains its enforcement responsibility to ensure compliance with the fundamental regulatory goals of the Act, as included within these rules. The Commission believes that it has retained the tools necessary to accomplish this mandate and by adopting a more flexible regulatory approach is not thereby indicating any diminishment in its resolve effectively to enforce compliance.

5. Procedures for Recognition

A board of trade, facility, or entity seeking recognition as a derivatives transaction facility would be deemed to be recognized thirty days after the Commission received the application if the application met the conditions for recognition pursuant to §§ 37.3 and 37.4 and the applicant and/or its rules or procedures do not violate the Act or the Commission's regulations.[37] An entity seeking recognition as a DTF may request that the Commission approve its initial set of rules, which may be trading protocols, and any subsequent rules or rule amendments under section 5a(a)(12)(A) of the Act and Commission regulations thereunder. However, the DTF is only required to notify the Commission of rules and rule amendments, which include trading protocols, in the same manner that it notifies market participants, but no later than close of business on the day preceding implementation.

Several commenters raised issues regarding the procedures for recognition. Kiodex, a risk management services firm, suggested that the applicant have an opportunity to correct a deficiency before the ''Commission convert the review into a full-scale designation proceeding.'' CL 21–29 at 4. However, proposed rule 37.4(c) merely provided that upon termination of review under the thirty-day period, the application would be subject to the ''procedures specified in section 6 of the Act.'' That provision merely incorporates the time periods and other procedures from section 6; it is not intended to convert the application or its review into one for contract market designation.

On a related point, the CBT suggested a technical modification to clarify that a board of trade or other entity that files for recognition as a DTF by certification is not required to demonstrate that it satisfies conditions for recognition under part 37. CL 21–36 at 10. As both the proposed and final rules provide, however, the filing by a facility which is already a designated contract market need only include the DTF's rules and its certification that it meets the conditions for recognition as a DTF under the part 37 rules.

Intercontinental suggested that the Commission specifically retain the flexibility to grant recognition to new facilities at various stages of readiness. CL 21–22 at 1–3. The Commission agrees, and has modified rule 37.4 as proposed to provide that the Commission may determine to recognize a DTF upon conditions. These might relate either to additional regulatory undertakings by a particular facility, or to recognition of a facility pending its subsequent fulfillment of a regulatory requirement. This flexibility will enable new entrants to apply for recognition before development of their trading system is complete and to be recognized contingent upon their

[36] This determination is based on the important role that floor brokers and floor traders, which are Commission registrants, may fulfill in trading on a Commission-recognized market under the part 37 exemption. For this reason, the Commission does not agree, as NYMEX suggests, that floor trades or floor brokers should be eligible participants for purposes of parts 35 and 36 under conditions other than currently provided.

[37] The Commission has made clear in the rule 37.1(a) scope provision that the part 37 rules apply to a ''a board of trade operating as a derivatives transaction facility.'' Moreover, DTFs, as a condition of the part 37 rules, generally would be considered under proposed rule 37.1(a) to be subject to the Act's provisions as though the DTF were a ''designated contract market'' under the Act. As a board of trade within the meaning of that term under the Act (and as a contract market by operation of part 37), a DTF on which futures transactions are traded would be covered by the provisions of Subchapter IV of Chapter 7, Title 11 of the Bankruptcy Code. Similarly, DTFs should be considered ''contract markets'' for the purpose of, for example, Sections 556 and 761 of the Bankruptcy Code, and 12 U.S.C. 4402. The Commission has modified final rule 38.1(b) to make a similar clarification relating to RFEs.

meeting all of the recognition requirements.[38]

6. Enforcement of Core Principles

Several letters raised concerns regarding the interpretation, enforcement and oversight of core principles. NYMEX suggested that the guidance with respect to Core Principle 6 which provides that rule 1.31 is the acceptable practice should be amended to read ''an acceptable but non-exclusive means regarding the form and manner for keeping records.'' CL 21–47 at 11. The Commission appreciates that the current wording does not appear to offer a high degree of flexibility in meeting this core principle. However, rule 1.31 was recently amended (64 FR 28910) and in its amended form provides a degree of flexibility in compliance. Moreover, rule 1.31's provisions are consistent with the record-keeping requirements of the Securities and Exchange Commission (SEC). In light of the importance of recordkeeping to the Commission's ability to fulfill its oversight function and the high number of Commission registrants that must also comply with similar SEC requirements, the Commission is adopting the guidance as proposed and will provide further guidance on acceptable record-keeping practices after additional study of the issue.

The CBT opined that ''safeguards should be provided to ensure that flexible standards do not become a license for the CFTC to dictate to exchanges.'' CL 21–1 at 2–3. In contrast, Mercatus objected to the use of core principles as too vague. *See* CL 21–57 at 7, 10. *See also* CL 21–45 at 3. The Commission finds both of these arguments unpersuasive. First, the core principles are specifically designed to afford flexibility to trading facilities to design innovative trading mechanisms in an expeditious manner. Second, this flexibility should not be confused with vagueness. While not like typical prescriptive regulations, the core principles nevertheless do set forth specific standards to be satisfied by those seeking to gain and maintain recognition. Finally, any interpretative advice, assistance or direction provided by the Commission would constitute guidance only. It does not preclude any facility from complying with the core principle in some other manner.

Accordingly, the framework does not place the burden of proof upon those covered by the framework to demonstrate why a particular practice that differs from the specific guidance offered in a statement of acceptable practices complies with a particular core principle. See, CL 21–57 at 7. If, as a practical matter, a disagreement on the interpretation of any core principle could not be addressed through informal mechanisms, the burden of proof to establish a violation of a core principle would not differ from the Commission's current burden, and would rest with the Commission in any formal regulatory or enforcement proceeding.

Nevertheless, the CBT and CME called for a ''mechanism'' for resolving disagreements over interpretation of core principles short of the CFTC taking punitive action. CL 21–51 at 5. CBT suggested, for example, that all adjectives, such as ''appropriate,'' ''periodically,'' ''proper,'' and ''timely'' be removed from the core principles and that the Commission ''structure an alternative dispute resolution mechanism to resolve disagreements about the application of core principles.'' CL 21–36 at 10. The Commission appreciates the concerns of these commenters. By moving from prescriptive rules to more general core principles, self-regulatory organizations will have not only greater flexibility in how they meet the regulatory requirements, but more responsibility, as well. Purging the core principles of adjectives will not address the issue of whether the self-regulatory organizations act in a manner consistent with these internationally accepted norms for the conduct of trading facilities. The Commission fully expects that as self-regulators, the entities covered by the framework will strive to act at the highest ethical and professional standards for the protection of customers and the integrity of the market.

Finally, trading facilities must recognize that the requirements contained in the core principles may involve many interested parties, not just a facility's members or owners. Accordingly, as FIA suggested, when issuing interpretative guidance having industry-wide application, the Commission will follow the notice and public comments procedures of the Administrative Procedure Act, as appropriate. CL 21–45 at 5.[39]

C. Recognized Futures Exchanges

The Commission further proposed to recognize all currently designated contract markets, except for those designated as contract markets in section 2(a)(1)(B) commodities, as ''Recognized Futures Exchanges'' under proposed part 38. To provide recognized futures exchanges with greater operational flexibility, part 38, as proposed, would replace many prescriptive rules with performance-based rules, or core principles. Moreover, Commission review would not be required for new contracts or for rules and rule amendments prior to listing or implementation, except for the terms and conditions of agricultural commodities enumerated in section 1a(3) of the Act. Furthermore, the exchanges would not be required to be responsible for auditing intermediaries' sales practices. Instead, enforcement could be the responsibility of a registered futures association.[40]

The preamble to proposed part 38 noted that RFE markets can list for trading contracts on any commodity, including those having potentially a greater risk of price manipulation. In addition, because they could permit unconditioned access to both institutional and non-institutional traders, they raise greater concerns regarding customer protection than do DTFs. 65 FR at 38991. Therefore, as the preamble noted, the proposed rules in part 38 preserve a higher level of market surveillance, position reporting obligations, customer protections and financial safeguards than do the proposed rules for DTFs. *Id.* A number of commenters questioned these requirements as incorporated in the core principles that are applicable to RFEs.

1. RFEs as a Means of Regulatory Reform

As was the case with commenters on the proposed DTF category, many commenters supported the general concept of changing from prescriptive regulations to broad, flexible core principles for RFEs.[41] Some

[38] The Commission has modified the final application guidances to make clear that DTFs and RFEs must disclosure limitations of liability, if any. Such limitations of liability, consistent with longstanding Commission policy, may not limit liability for violations of the Act or Commission rules, fraud, or wanton or willful misconduct.

[39] The National Futures Association (NFA) advocated that its member rules be the primary means of developing best practice or other interpretative guidance for core principles applying the framework. The Commission appreciates the NFA's willingness to assist in interpreting Commission rules and in certain instances, where the parts of the framework involve NFA's member rules, the Commission may ask for NFA's interpretative assistance. However, it would be inappropriate for NFA to assume that role for areas of the framework that do not involve its membership, particularly for example, where a trading facility does not permit intermediation.

[40] As pointed out in the Federal Register release proposing part 38, the NFA currently is the only such registered organization. *See* 65 FR at 38991.

[41] Specifically, for example, Cargill supported the basic structure of the regulatory relief for organized

Continued

commenters expressed concern, however, that the RFE proposal would permit greater deregulation than appropriate for these commodities and market participants. For example, the Silver Users Association (SUA) maintained that any change in the regulatory structure for silver trading must provide clear assignment of responsibility for trading facility operators, and procedures for market participants to obtain redress for improper actions.[42] The agricultural producer groups urged that new agricultural contracts and amendments to such contracts continue to be subject to Commission review prior to their trading. CL 21–60 at 1. Two commenters, Mercatus and CBT, questioned whether the proposed framework for RFEs was sufficiently deregulatory in nature. CL 21–36 at 12.

The Commission remains convinced, and most commenters agreed, that the use of core principles supplemented by statements of acceptable practices strikes the right balance between the need for appropriate regulation and for flexibility. The proposed rules for RFEs are not intended to remove internationally accepted standards for market or financial integrity or for the protection of customers trading on futures exchanges. Rather, they are intended to offer U.S. exchanges greater flexibility in meeting those requirements. As the Commission noted:

> [t]hese proposed rules * * * [are] intended to provide greater flexibility in meeting technological and competitive challenges. At the same time, the Commission will retain its oversight authority to ensure the integrity of markets and prices, to deter manipulation, to protect the markets' financial integrity, and to protect customers.

65 FR at 38987. This approach, although providing exchanges a high degree of flexibility to meet these challenges, is not intended to relieve U.S. exchanges from their obligations to comply with the policies and requirements of the Act, nor to operate in a manner that fails to meet ''internationally-accepted guidance regarding appropriate regulatory measures for exchange-traded derivatives markets.''[43] 65 FR at 38987.

2. Comments Concerning the Core Principles

A number of commenters offered suggested changes to the core principles. The Commission has considered these comments within the overall goal that the core principles establish broad, flexible requirements, that at the same time are specific enough to provide notice of the required performance by the recognized entity. In this regard, the final version of Appendix A to part 38 herein, clarifies that the guidance offered on the means of complying with the core principles is for illustrative purposes only and is not intended to be a mandatory checklist for compliance.

Specifically, AIMR suggested that Core Principle 3 (Position Monitoring and Reporting) should simply require exchanges to have the process and rules necessary to deter market manipulation. CL 21–64 at 4. That formulation, however, fails to capture the breadth of an RFE's responsibility under the Act. Both prevention of price manipulation and assurance of market and price integrity are fundamental public policy interests of the Act. Accordingly, the Commission believes that it is vital that RFEs have more than just rules and a process to deter manipulation, as suggested by AIMR. The Commission therefore is retaining the language of Core Principle 3, which requires an RFE to monitor ''on a routine and non-routine basis as necessary to prevent manipulation, price distortion, and disruptions of the delivery or cash settlement process.''[44]

NYBOT and CBT expressed concerns about Core Principle 7, which relates to transparency. NYBOT raised the concern that the required level of transparency under Core Principle 7 should be appropriate to the method of order execution, explaining that some aspects of transparency are affected by whether trading is electronic or open-outcry (*e.g.*, bids and offers are not automatically captured in open-outcry trading). CL 21–7 at 3, CL 21–27 at 2. However, technology is rapidly transforming futures markets and the core principles are intended to be understood broadly and applied flexibly in each particular market context. Accordingly, the Commission believes that the transparency requirement, as proposed, provides the necessary guidance for both open-outcry and electronic markets. The CBT suggested that the Commission revise the DTF Transparency Core Principle to mirror the proposed RFE Transparency Core Principle, commenting that DTFs appear to have the more onerous transparency burden. CL 21–36 at 10. The material difference between the two core principles is that the DTF Transparency Core Principle requires disclosure of information to both market participants and the public. That requirement is particularly necessary at the DTF level in light of the framework's greater reliance on disclosure rather than merit-type regulation.

Upon further consideration, however, the Commission believes that the Transparency Core Principle proposed to apply to DTFs should be applied at the RFE level, as well. The RFE Transparency Core Principle as proposed could result in permitting an inappropriate reduction in the information currently available to market participants. Therefore, under the final Transparency Core Principle, both RFEs and DTFs must provide information to market participants, on a fair, equitable and timely basis, regarding prices, bids and offers, as well as other pertinent information as appropriate to the market. This additional language is not intended to interfere with the current practice of futures exchanges of selling price and other market information through various information vendors.

FIA suggested in its comment that the guidance regarding price and reporting time as it relates to block trading should be eliminated from Appendix A, Core Principle 8.[45] CL 21–45 at 6–7. The

futures exchanges. CL 21–49 at 2. NYMEX strongly supported the overall design of the proposal. CL 21–47 at 1. CME strongly supported the Commission's approach in moving from prescriptive regulations to core principles. CL 21–51 at 5. NYBOT stated that the proposed framework struck a measured balance between self-regulation and federal oversight in many respects. CL 21–27 at 1.

[42] The SUA expressed the additional concern that if liquidity in silver trading at RFEs using open-outcry diminishes due to interest in electronic platforms, procedures should be in place for making pricing data from electronic trading platforms available to the public on a timely basis. CL 21–39 at 3.

[43] Under Rule 38.3(f), as modified in the final rules, RFEs are required to carry out international financial and surveillance information sharing arrangements. The Commission points out that, at this time, the International Information Sharing Agreement and Memorandum of Understanding developed by the FIA Global Task Force on Financial Integrity is one such arrangement.

[44] AIMR also suggested that Core Principle 4 (Position Limits) be modified only to require RFEs to hold members accountable for their positions. However, position limits are a necessary tool for preventing market manipulation or distortion in many markets and the Commission therefore declines to modify the core principle as proposed. However, the Commission in its proposed statement of acceptable practices specifically determined that exchange position accountability rules are an acceptable means of meeting the core principle for various types of markets. 65 FR at 39005.

[45] Core Principle 8 requires an RFE to ''provide a competitive, open and efficient market.'' A primary goal of the Commission's framework is to ensure that prices discovered in futures and derivatives markets are accurate and reflective of current supply and demand conditions in the markets. Core Principle 8 specifically includes the concept of ''efficient'' markets in order to make clear that trading systems that discover prices reflective of the forces of supply and demand and accurately reflect publicly held information may include certain practices, such as block trades, that permit large traders to enter the market with a single trade as opposed to having to execute

Commission understands the difficulties in implementing both the ''fair and reasonable price'' and ''transparency'' guidance. Nevertheless, current block trading provisions meet both such criteria, and the Commission believes it appropriate to retain them at this time. In this regard, the Commission notes that the reporting time provision is not the ''specific timing requirement'' referred to by FIA, but a provision for transparency of the block trade, directing that the trade be reported ''within a reasonable period of time.''(emphasis added). 65 FR at 39006. Without such transparency, the market's price discovery role would be harmed. The Commission may reconsider this guidance in the future if, in practice, these criteria prove to be unworkable.[46]

NYBOT suggested that requiring all RFEs on which intermediaries trade to have relevant rules under Core Principle 10 (Financial Standards) would impose a new, onerous burden, and might result in conflicting rules being implemented at different RFEs. NYBOT states that segregation of customer and proprietary funds and custody and investment of customer funds are currently governed by Commission rules implemented under the auspices of a designated self-regulatory organization. CL 21–7 at 2. The adoption of Core Principle 10 is not intended to impose a ''new, onerous burden'' on exchanges, to change current systems in place for the oversight of intermediaries nor to discourage the voluntary harmonization of rules by the exchanges through the operation of organizations such as the Joint Audit Committee.

The Commission has modified Core Principle 15 in response to concerns that it inadvertently could impose a duty different in form or degree from the antitrust statutes and court decisions construing them. *See, e.g.,* comment of the Board of Trade Clearing Corporation, CL 21–20 at 13. Final Core Principle 15 requires that RFEs operate in a manner consistent with the public interest to be protected by the antitrust laws. The Commission itself remains subject to the requirements of section 15 of the Act, and will continue to take into consideration the public interest to be protected by the antitrust laws and to endeavor to take the least anticompetitive means of achieving the objectives of the Act in requiring or approving any bylaw, rule or regulation of any facility recognized under this framework.[47]

3. New Products and Rules and Amendments Thereof

The Commission proposed that alteration by RFEs of the terms and conditions of futures contracts on the enumerated agricultural contracts be subject to prior review and approval by the Commission. The NYBOT, MGE, CBT, and CME opposed this provision, arguing that RFEs should be permitted to alter the terms or conditions of agricultural contract terms and conditions by self-certification, the same process permitted for contracts on all other commodities.[48] In contrast to the exchange commenters, a number of commenters representing agricultural interests specifically supported retention of the proposed 45-day prior approval requirement for changes to the terms and conditions of existing agricultural contracts.[49] Concern was also raised by the National Cotton Council and the agricultural producers groups regarding the certification process for new contracts. CL 21–54 at 1. They suggested that Commission prior approval under a 45-day review period be required for new agricultural contracts, as well as for alterations of existing contracts.[50] CL 21–60 at 2.

The Commission concurs with the agricultural producers groups that, as ''agricultural futures markets serve as the price discovery mechanism for agricultural commodities, any changes to these markets can have a significant impact on farmers and ranchers.'' CL 21–60 at 2. In light of their reliance on the existing futures markets for price discovery, the Commission concurs that agricultural producers, processors and merchants have an interest in commenting on significant alterations to the terms of contracts prior to their implementation. Accordingly, the Commission is adopting the prior approval provision for amendments to contract terms and conditions, as proposed. However, the Commission does not agree that the same opportunity for comment is necessary for new contracts, upon which producers have not previously relied. The success of a new contract will rest on its attractiveness to market participants and the marketplace will determine whether the terms and conditions of a new contract offer a reliable price discovery mechanism. Accordingly, the Commission has decided to permit an RFE to list new agricultural contracts by self-certification, as proposed.

Several commenters opposed Commission authority to stay the effectiveness of rules implemented by exchange certification during a Commission action to disapprove those rules. *See,* rule 1.41(c)(4) as amended.[51] They argued that such stays could disrupt the marketplace.[52] However, under the rule, 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. The Commission anticipates that it will stay implementation of an RFE rule only in limited and egregious situations, where, for example, one or more core principles

numerous small trades. By including ''efficiency'' in addition to open and competitive markets, the Commission is promoting a flexible standard that protects the price discovery process of the markets while permitting a variety of trading practices.

[46] AIMR recommended that the Commission reword Core Principle 8 as an RFE should not only provide for, but should also facilitate the appearance of, a competitive, open and efficient market (trading system). CL 21–64 at 4. The final version of Core Principle 8 does not include the additional language proposed by AIMR. The Commission believes that provision of an open and competitive market would also promote the appearance of such a market, without the need explicitly to so require.

[47] Section 15 of the Act is also reserved under rule 38.6(a). Section 15 of the Act requires the Commission to take into consideration the public interest to be protected by the antitrust laws and to endeavor to take the least anticompetitive means of achieving the objectives of the Act in issuing any order, adopting any regulation, or approving any rule.

[48] *See* CL 21–7 at 2, 4; CL 21–24 at 3–4; CL 21–36 at 11; CL 21–51 at 5.

[49] *See* CL 21–52 at 1–2 (National Cattlemen's Beef Association); CL 21–54 at 1 (The National Cotton Council of America, ''National Cotton Council''); CL 21–60 at 1–2 (agricultural producers groups).

[50] The comment letter stated that the agricultural organizations were concerned that exchanges could use the ability to offer a new contract with one day's notice to avoid prior review and approval for amendments and changes to agricultural contracts. It could also cause market fragmentation, since new trading facilities might test new contracts on the market without a thorough prior business analysis.

[51] Amendments to Commission rule 1.41 were proposed as part of the new regulatory framework. These amendments, appearing in the final version in this **Federal Register** release, allow an RFE to make modifications to its rules (other than terms or conditions of contracts on the commodities enumerated in section 1a(3) of the Act) by certification to the Commission that the new or amended rule does not violate the Act or the Commission's regulations. Upon the adoption of the attached amendments to Commission rule 1.41, the Commission's earlier certification proposal, published as a proposed rule on November 26, 1999 (64 FR 55428), will be unnecessary. Therefore, the Commission is withdrawing proposed rule 1.41(z) at this time.

[52] *See, e.g.,* CL 21–24 at 4 (assertions by MGE that rules should not be stayed absent sufficient evidence that market participants will suffer material harm). *See also* CL 21–27 at 3 (conclusions by NYBOT that staying a rule pending a proceeding to disapprove or amend it could take months, and the uncertainty thus created would deter traders); CL 21–36 at 11–12 (statement by CBT that it could be detrimental for the Commission to retain authority to impose a stay during a proceeding to disapprove, alter, or amend an RFE rule as stays could disrupt the marketplace); CL 21–51 at 5 (observation by CME that the Commission should not retain authority to stay operation of an exchange rule as, in an emergency situation, the Commission could act under section 8a(9) of the Act, without advance notice or a hearing).

were being violated, but that the Commission's emergency authority would not apply.[53] In such serious situations, the Commission believes that the unavailability of a stay could cause significantly more disruptive effects than imposition of a stay in appropriate situations. In those rare instances, the absence of a stay could cause significantly greater harm to the market than its use. The Commission has determined that this authority is central to its ability to oversee the operation of RFEs consistent with its responsibilities under the Act.

4. Bankruptcy Status

Several commenters requested that the Commission clarify that transactions on both DTFs and RFEs continue to enjoy the same Bankruptcy Code status as transactions on a designated contract market.[54] As noted above, recognized RFEs and DTFs are both ''boards of trade'' within the meaning of the Act, and pursuant to these regulations, are deemed to be subject to all provisions of the Act and Commission rules applicable to a ''designated contract market.'' *See, e.g.,* rule 38.1(b). Moreover, final part 38 explicitly reserves the applicability of part 190 to part 38 transactions. Accordingly, as explained in footnote 37 above, as a board of trade within the meaning of that term under the Act (and as a contract market by operation of part 38), transactions on RFEs (and DTFs) would be covered by the provisions of Subchapter IV of Chapter 7, Title 11 of the Bankruptcy Code, which apply to futures contracts (or options) traded on or subject to the rules of a board of trade or contract market.[55]

III. Section 4(c) Findings

These rule amendments 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, either unconditionally or on stated terms or conditions from any of the requirements of any provision of the Act. For any exemption granted pursuant to 4(c), the Commission must find that the exemption would be consistent with the public interest. For any exemption granted pursuant to 4(c) from the requirements of section 4(a), the Commission must further find that the section 4(a) requirement(s) should not be applied to the agreement, contract or transaction to be exempted, that the exemption would be consistent with the public interest and the purposes of the Act, that the agreement, contract, or transaction to be exempted would be entered into solely between appropriate persons and that the exemption 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.[56]

The Commission specifically requested the public to comment on these issues. The Commission finds and the commenters overwhelmingly concurred that the proposed regulatory framework would be in the public interest. As explained above, these proposed rules establish a new regulatory framework. The proposed framework is intended to promote innovation and competition in futures trading and to permit the markets the flexibility to respond to technological and structural changes. Consequently, the Commission finds that section 4(a) requirements should not be applied to agreements, contracts or transactions executed pursuant to parts 36, 37 or 38 except as provided for in each part, respectively. Moreover, the proposed framework establishes three regulatory tiers with regulations tailored to the nature of the commodities traded and the nature of the market participant. As the Commission explained above, access to each of the tiers is dependent upon the appropriateness of the participant.

Accordingly, and for the reasons detailed above, the Commission finds that each class of participant eligible to participate in a specific tier is appropriate for that exemptive relief. Finally, the exemptions for parts 37 and 38 are upon stated terms. As detailed above, these terms include application of regulatory and self-regulatory requirements tailored to the nature of the market. In light of these conditions, this exemptive relief would have no adverse effect on any of the regulatory or self-regulatory responsibilities imposed by the Act and the exemptions are consistent with the purposes of the Act.

IV. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA), 5 U.S.C. 601, *et seq.* (1994 & Supp. II 1996), requires federal agencies, in promulgating rules, to consider the impact of those rules on small entities. The rules adopted herein would affect contract markets, FCMs, CTAs, Floor Brokers and Floor Traders. The Commission has previously established certain definitions of ''small entities'' to be used by the Commission in evaluating the impact of its rules on small entities in accordance with the RFA.[57] In its previous determinations, the Commission has concluded that contract markets and registered FCMs are not small entities for the purpose of the RFA.[58] With respect to CTAs, Floor Brokers and Floor Traders, the Commission has stated that it is appropriate to evaluate within the context of a particular rule proposal whether some or all of the 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 allow qualifying CTAs, floor brokers and floor traders to access trading in less regulated futures markets than is currently the case; consequently, these rules should not have any, or result in only a de minimus, increase in the regulatory requirements that apply to CTAs, Floor Brokers and Floor Traders. Accordingly, the Commission does not expect the rules, as adopted herein, to have a significant economic impact on a substantial number of small entities. Furthermore, no comments were received from the public on the RFA and its relation to the proposed rules. Therefore, 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.

B. Paperwork Reduction Act of 1995

These parts 15, 37, 38 contain information collection requirements. As required by the Paperwork Reduction Act of 1995 (Pub. L. 104–13 (May 13,

[53] For example, a rule that altered a trade matching algorithm to give one class of participants a significant and improper ongoing advantage over another or that had a continuing significant adverse affect on customers could be the subject of a stay. In contrast, such a rule might not be a proper basis for a market emergency, as it might not result in a situation where action was necessary to ensure that the market accurately reflected the forces of supply and demand. The term ''emergency'' as defined in the Act means, in addition to threatened or actual market manipulations and corners, any act of the United States or a foreign government affecting a commodity or any other major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for such commodity. *See* section 8a(9) of the Act.

[54] *See, e.g.,* CL 21–65 at 22.

[55] Similarly, the Commission believes that transactions on recognized DTFs and RFEs should be subject to the same tax treatment as transactions on formally designated contract markets.

[56] *See* 7 U.S.C. 6(c).

[57] 47 FR 18618–21 (Apr. 30, 1982).

[58] 47 FR 18618, 18619 (discussing contract markets); 47 FR 18619–20 (discussing FCMs and CPOs).

1996)), the Commission has submitted a copy of these proposed parts to the Office of Management and Budget (OMB) for its review (44 U.S.C. 3504(h)). No comments were received in response to the Commission's invitation in the NPRM to comment on any potential paperwork burden associated with these regulations.

List of Subjects

17 CFR Part 1

Commodity futures, Consumer protection, Contract markets, Designation application, Reporting and recordkeeping requirements.

17 CFR Part 5

Authority delegations (Government agencies), Commodity futures, Contract markets, Designation application, Reporting and recordkeeping requirements.

17 CFR Part 15

Commodity futures, Contract markets, Reporting and recordkeeping requirements.

17 CFR Part 36

Commodity futures, Commodity Futures Trading Commission.

17 CFR Part 37

Authority delegations (Government agencies), Commodity futures, Commodity Futures Trading Commission.

17 CFR Part 38

Commodity futures, Commodity Futures Trading Commission.

17 CFR Part 100

Commodity futures, Commodity Futures Trading Commission.

17 CFR Part 170

Authority delegations (Government agencies), Commodity futures, Reporting and recordkeeping requirements.

17 CFR Part 180

Claims, Commodity futures, Consumer protection, Reporting and recordkeeping requirements.

In consideration of the foregoing, and pursuant to the authority contained in the Act and, in particular, sections 4, 4c, 4i, 5, 5a, 6 and 8a thereof, 7 U.S.C. 6, 6c, 6i, 7, 7a, 8, and 12a, the Commission hereby amends Chapter I of Title 17 of the Code of Federal Regulations as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. The authority citation for Part 1 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 2a, 4, 4a, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 6p, 7, 7a, 7b, 8, 9, 12, 12a, 12c, 13a, 13a–1, 16, 16a, 19, 21, 23, and 24.

2. Section 1.37 is amended by adding paragraphs (c) and (d) to read as follows:

§ 1.37 Customer's or option customer's name, address, and occupation recorded; record of guarantor or controller of account.

* * * * *

(c) Each recognized futures exchange shall keep a record in permanent form which shall show the true name; address; and principal occupation or business of any foreign trader executing transactions on the facility or exchange, as well as the name of any person guaranteeing such transactions or exercising any control over the trading of such foreign trader.

(d) Paragraph (c) of this section shall not apply to a recognized futures exchange on which transactions in futures or option contracts of foreign traders are executed through and the resulting transactions are maintained in accounts carried by a registered futures commission merchant or introducing broker subject to the provisions of paragraph (a) of this section.

* * * * *

3. Section 1.41 is amended as follows:

a. By revising paragraph (a)(1),

b. By removing and reserving paragraph (b), and removing paragarphs (i) through (t),

c. By redesignating paragraph (e) as paragraph (i) and revising it,

d. By revising paragraphs (c) and (d) and adding (e), and

e. By amending paragraphs (f) and (g) by adding the words ''or recognized futures exchange'' after the words ''contract market'' each time they appear, to read as follows:

§ 1.41 Contract market rules; submission of rules to the Commission; exemption of certain rules.

(a) * * *

(1) The term rule of a contract market means any constitutional provision, article of incorporation, bylaw, rule, regulation, resolution, interpretation, stated policy, term and condition, trading protocol, agreement or instrument corresponding thereto, in whatever form adopted, and any amendment or addition thereto or repeal thereof, made or issued by a contract market, or by the governing board thereof or any committee thereof.

* * * * *

(b) [Reserved]

(c) *Exemption from the rule review procedure requirements of section 5a(a)(12)(A) of the Act and related regulations.* Notwithstanding the rule approval and filing requirements of section 5a(a)(12) of the Act, designated contract markets, recognized futures exchanges and recognized clearing organizations may place a rule into effect without prior Commission review or approval if:

(1) The rule is not a term or condition of a contract for future delivery of an agricultural commodity listed in section 1a(3) of the Act;

(2) The entity has filed a submission for the rule, and the Commission has received the submission at its Washington, D.C. headquarters and at the regional office having jurisdiction over the entity by close of business on the business day preceding implementation of the rule; and

(3) The rule submission includes:

(i) The label, ''Submission of rule by self-certification;'

(ii) The text of the rule (in the case of a rule amendment, brackets must indicate words deleted and underscoring must indicate words added);

(iii) A brief explanation of the rule including any substantive opposing views not incorporated into the rule; and

(iv) A certification by the eligible entity that the rule does not violate any provision of the Act and regulations thereunder.

(4) The Commission retains the authority to stay the effectiveness of a rule implemented pursuant to paragraph (c)(1) of this section during the pendency of Commission proceedings to disapprove, alter or amend the rule. The decision to stay the effectiveness of a rule in such circumstances may not be delegable to any employee of the Commission.

(d)(1) *Voluntary submission of rules for fast-track approval.* A designated contract market, recognized futures exchange, derivatives transaction facility or recognized clearing organization may submit any rule or proposed rule (which may be terms or conditions of trading or trading protocols), except those submitted to the Commission under paragraph (f) of this section, for approval by the Commission pursuant to section 5a(a)(12)(A) of the Act, whether or not so required by section 5a(a)(12) of the Act under the following procedures:

(i) One copy of each rule submitted under this section shall be furnished in hard copy or electronically in a format specified by the Secretary of the Commission to the Commission at its Washington, DC headquarters. If a hard copy is furnished for submissions under appendix A to part 5 of this chapter, two additional hard copies shall be furnished to the Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street NW., Washington, DC 20581. Each submission under this paragraph (d)(1) shall be in the following order:

(A) Label the submission as ''Submission for Commission rule approval'';

(B) Set forth the text of the rule or proposed rule (in the case of a rule amendment, brackets must indicate words deleted and underscoring must indicate words added);

(C) Describe the proposed effective date of a proposed rule and any action taken or anticipated to be taken to adopt the proposed rule by the contract market, recognized futures exchange, derivatives transaction facility or recognized clearing organization or by its governing board or by any committee thereof, and cite the rules of the entity that authorize the adoption of the proposed rule;

(D) Explain the operation, purpose, and effect of the proposed rule, including, as applicable, a description of the anticipated benefits to market participants or others, any potential anticompetitive effects on market participants or others, how the rule fits into the contract market, recognized futures exchange, derivatives transaction facility or recognized clearing organization's framework of self-regulation, and any other information which may be beneficial to the Commission in analyzing the proposed rule. If a proposed rule affects, directly or indirectly, the application of any other rule of the submitting entity, set forth the pertinent text of any such rule and describe the anticipated effect;

(E) Note and briefly describe any substantive opposing views expressed with respect to the proposed rule which were not incorporated into the proposed rule prior to its submission to the Commission; and

(F) Identify any Commission regulation that the Commission may need to amend, or sections of the Act or Commission regulations that the Commission may need to interpret in order to approve or allow into effect the proposed rule. To the extent that such an amendment or interpretation is necessary to accommodate a proposed rule, the submission should include a reasoned analysis supporting the change.

(ii) All rules submitted for Commission approval under paragraph (d)(1)(i) of this section shall be deemed approved by the Commission under section 5a(a)(12)(A) of the Act, forty-five days after receipt by the Commission, unless notified otherwise within that period, if:

(A) The submission complies with the requirements of paragraphs (d)(1)(i) (A) through (F) of this section or, for dormant contracts, the requirements of § 5.3 of this chapter;

(B) The submitting entity does not amend the proposed rule or supplement the submission, except as requested by the Commission, during the pendency of the review period; and

(C) The submitting entity has not instructed the Commission in writing during the review period to review the proposed rule under the 180 day review period under section 5a(a)(12)(A) of the Act.

(iii) The Commission, within forty-five days after receipt of a submission filed pursuant to paragraph (d)(1)(i) of this section, may notify the entity making the submission that the review period has been extended for a period of thirty days where the proposed rule raises novel or complex issues which require additional time for review or is of major economic significance. This notification shall briefly describe the nature of the specific issues for which additional time for review is required. Upon such notification, the period for review shall be extended for a period of thirty days, and, unless the entity is notified otherwise during that period, the rule shall be deemed approved at the end of the enlarged review time.

(iv) During the forty-five day period for fast-track review, or the thirty-day extension when the period has been enlarged under paragraph (d)(1)(iii) of this section, the Commission shall notify the submitting entity that the Commission is terminating fast-track review procedures and will review the proposed rule under the 180 day review period of section 5a(a)(12)(A) of the Act, if it appears that the proposed rule may violate a specific provision of the Act, regulations, or form or content requirements of this section. This termination notification will briefly specify the nature of the issues raised and the specific provision of the Act, regulations, or form or content requirements of this section that the proposed rule appears to violate. Within fifteen days of receipt of this termination notification, the designated contract market, recognized futures exchange, derivatives transaction facility or recognized clearing organization may:

(A) Withdraw the rule;

(B) Request the Commission to review the rule pursuant to the one hundred and eighty day review procedures set forth in section 5a(a)(12)(A) of the Act; or

(C) Request the Commission to render a decision whether to approve the proposed rule or to institute a proceeding to disapprove the proposed rule under the procedures specified in section 5a(a)(12)(A) of the Act by notifying the Commission that the submitting entity views its submission as complete and final as submitted.

(2) *Voluntary submission of rules for expedited approval.* Notwithstanding the provisions of paragraph (d)(1) of this section, changes to terms and conditions of a contract that are consistent with the Act and Commission regulations and with standards approved or established by the Commission in a written notification to the market or clearing organization of the applicability of this paragraph (d)(2) shall be deemed approved by the Commission at such time and under such conditions as the Commission shall specify, provided, however, that the Commission may at any time alter or revoke the applicability of such a notice to any particular contract.

(e)(1) *Notification of rule amendments.* Notwithstanding the rule approval and filing requirements of section 5a(a)(12) of the Act and of paragraphs (c) and (d) of this section, designated contract markets, recognized futures exchanges and recognized clearing organizations may place the following rules into effect without prior notice to the Commission if the following conditions are met:

(i) The designated contract market, recognized futures exchange, or recognized clearing organization provides to the Commission at least weekly a summary notice of all rule changes made effective pursuant to this paragraph during the preceding week. Such notice must be labeled ''Weekly Notification of Rule Changes'' and need not be filed for weeks during which no such actions have been taken. One copy of each such submission shall be furnished in hard copy or electronically in a format specified by the Secretary of the Commission to the Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street NW., Washington, DC 20581; and

(ii) The rule change governs:

(A) *Nonmaterial revisions.* Corrections of typographical errors, renumbering, periodic routine updates to identifying information about

approved entities and other such nonsubstantive revisions of contract terms and conditions that have no effect on the economic characteristics of the contract;

(B) *Delivery standards set by third parties.* Changes to grades or standards of commodities deliverable on futures contracts that are established by an independent third party and that are incorporated by reference as terms of the contract, provided that the grade or standard is not established, selected or calculated solely for use in connection with futures or option trading;

(C) *Index contracts.* Routine changes in the composition, computation, or method of selection of component entities of an index other than a stock index referenced and defined in the contract's terms, made by an independent third party whose business relates to the collection or dissemination of price information and that was not formed solely for the purpose of compiling an index for use in connection with a futures or option contract;

(D) *Transfer of membership or ownership.* Procedures and forms for the purchase, sale or transfer of membership or ownership, but not including qualifications for membership or ownership, any right or obligation of membership or ownership or dues or assessments; or

(E) *Administrative procedures.* The organization and administrative procedures of a contract market's governing bodies such as a Board of Directors, Officers and Committees, but not voting requirements and procedures or requirements or procedures relating to conflicts of interest.

(2) *Notification of rule amendments not required.* Notwithstanding the rule approval and filing requirements of section 5a(a)(12) of the Act and of paragraphs (c) and (d) of this section, designated contract markets, recognized futures exchanges and recognized clearing organizations may place into effect without notice to the Commission, rules governing:

(i) *Administration.* The routine, daily administration, direction and control of employees, requirements relating to gratuity and similar funds, but not guaranty, reserves, or similar funds; declaration of holidays, and changes to facilities housing the market, trading floor or trading area; or

(ii) *Standards of decorum.* Standards of decorum or attire or similar provisions relating to admission to the floor, badges, visitors, but not the establishment of penalties for violations of such rules.

* * * * *

(i) *Membership lists.* Upon request of the Commission each designated contract market, recognized futures exchange or recognized clearing organization shall promptly furnish to the Commission a current list of the facility's or entity's members or owners subject to fitness requirements.

§§ 1.43, 1.45 and 1.50 [Removed]

4. In part 1, §§ 1.43, 1.45, and 1.50 are proposed to be removed and reserved.

5. Part 5 is amended as follows:

PART 5—PROCEDURES FOR LISTING NEW PRODUCTS

a. The authority citation for part 5 continues to read as follows:

Authority: 7 U.S.C. 6(c), 6c, 7, 7a, 8 and 12a.

b. The heading of part 5 is revised as set forth above and §§ 5.1 through 5.3 are revised to read as follows:

§ 5.1 Listing contracts for trading by exchange certification.

(a) Notwithstanding the provisions of section 4(a)(1) of the Act or § 33.2 of this chapter, a board of trade that has been recognized by the Commission as a recognized futures exchange under part 38 of this chapter may list for trading contracts of sale of a commodity for future delivery or commodity option contracts, if the recognized futures exchange:

(1) Lists for trading at least one contract which is not dormant within the meaning of § 5.3;

(2) In connection with the trading of the contract complies with all requirements of the Act and Commission regulations thereunder applicable to the recognized futures exchange under part 38 of this chapter;

(3) Files with the Commission at its Washington, D.C., headquarters either in electronic or hard-copy form a copy of the contract's initial terms and conditions and a certification by the recognized futures exchange that the contract's initial terms and conditions do not violate any requirement of part 38 of this chapter, any applicable provision of the Act or of the rules thereunder, and the filing is received no later than the close of business of the business day preceding the contract's initial listing; and

(4) Identifies the contract in its rules as listed for trading pursuant to exchange certification.

(b) The provisions of this section shall not apply to:

(1) A contract subject to the provisions of section 2(a)(1)(B) of the Act;

(2) A contract to be listed initially for trading that is the same or substantially the same as one for which an application for Commission review and approval pursuant to § 5.2 was filed by another board of trade while the application is pending before the Commission; or

(3) A contract to be listed initially for trading that is the same or substantially the same as one which is the subject of a pending Commission disapproval proceeding under section 6 of the Act, to disapprove a term or condition under section 5a(a)(12) of the Act, to alter or supplement a term or condition under section 8a(7) of the Act, to amend terms or conditions under section 5a(a)(10) of the Act, to declare an emergency under section 8a(9) of the Act, or to any other proceeding the effect of which is to disapprove, alter, supplement, or require a contract market or a recognized futures exchange to adopt a specific term or condition, trading rule or procedure, or to take or refrain from taking a specific action.

§ 5.2 Voluntary submission of new products for Commission review and approval.

(a) *Cash-settled contracts.* A new contract to be listed for trading by a recognized futures exchange under part 38 of this chapter or a recognized derivatives transaction facility under part 37 of this chapter shall be deemed approved by the Commission ten business days after receipt by the Commission of the application for contract approval, unless notified otherwise within that period, if:

(1) The submitting entity labels the submission as being submitted pursuant to Commission rule 5.2—Fast Track Ten-Day Review;

(2)(i) The application for approval is for a futures contract providing for cash settlement or for delivery of a foreign currency for which there is no legal impediment to delivery and for which there exists a liquid cash market; or

(ii) For an option contract that is itself cash-settled, is for delivery of a foreign currency that meets the requirements of paragraph (a)(2)(i) of this section or is to be exercised into a futures contract which has already been designated as a contract market or approved under this section;

(3) The application for approval is for a commodity other than those enumerated in section 1a(3) of the Act or one that is subject to the procedures of section 2(a)(1)(B) of the Act;

(4) The submitting entity trades at least one contract which is not dormant within the meaning of this part;

(5) The submission complies with the requirements of Appendix A of this part—Guideline No. 1;

(6) The submitting entity does not amend the terms or conditions of the proposed contract or supplement the application for designation, except as requested by the Commission or for correction of typographical errors, renumbering or other such nonsubstantive revisions, during that period; and

(7) The submitting entity has not instructed the Commission in writing during the review period to review the application for designation under the usual procedures under section 6 of the Act.

(b) *Contracts for physical delivery.* A new contract to be listed for trading by a recognized futures exchange under part 38 of this chapter or by a derivatives transaction facility under part 37 of this chapter shall be deemed approved by the Commission forty-five days after receipt by the Commission of the application for contract approval, unless notified otherwise within that period, if:

(1) The submitting entity labels the submission as being submitted pursuant to Commission rule 5.2—Fast Track Forty-Five Day Review;

(2) The application for contract approval is for a commodity other than those subject to the procedures of section 2(a)(1)(B) of the Act;

(3) The submitting entity lists for trading at least one contract which is not dormant within the meaning of this part;

(4) The submission complies with the requirements of Appendix A to this part—Guideline No. 1;

(5) The submitting entity does not amend the terms or conditions of the proposed contract or supplement the application for designation, except as requested by the Commission or for correction of typographical errors, renumbering or other such nonsubstantive revisions, during that period; and

(6) The submitting entity has not instructed the Commission in writing during the forty-five day review period to review the application for designation under the usual procedures under section 6 of the Act.

(c) *Notification of extension of time.* The Commission, within ten days after receipt of a submission filed under paragraph (a) of this section, or forty-five days after receipt of a submission filed under paragraph (b) of this section, may notify the submitting entity that the review period has been extended for a period of thirty days where the application for approval raises novel or complex issues which require additional time for review. This notification will briefly specify the nature of the specific issues for which additional time for review is required. Upon such notification, the period for fast-track review of paragraphs (a) and (b) of this section shall be extended for a period of thirty days.

(d) *Notification of termination of fast-track procedures.* During the fast-track review period provided under paragraphs (a) or (b) of this section, or of the thirty-day extension when the period has been enlarged under paragraph (c) of this section, the Commission shall notify the submitting entity that the Commission is terminating fast-track review procedures and will review the proposed contract under the usual procedures of section 6 of the Act, if it appears that the proposed contract may violate a specific provision of the Act, regulations, or form or content requirements of Appendix A to this part. This termination notification will briefly specify the nature of the issues raised and the specific provision of the Act, regulation, or form or content requirement of Appendix A to this part that the proposed contract appears to violate. Within ten days of receipt of this termination notification, the submitting entity may request that the Commission render a decision whether to approve the designation or to institute a proceeding to disapprove the proposed application for designation under the procedures specified in section 6 of the Act by notifying the Commission that the exchange views its application as complete and final as submitted.

(e) *Delegation of authority.* (1) The Commission hereby delegates, until it orders otherwise, to the Director of the Division of Economic Analysis or to the Director's delegatee, with the concurrence of the General Counsel or the General Counsel's delegatee, authority to request under paragraphs (a)(6) and (b)(5) of this section that the recognized futures exchange or derivatives transaction facility amend the proposed contract or supplement the application, to notify a submitting entity under paragraph (c) of this section that the time for review of a proposed contract term submitted for review under paragraphs (a) or (b) of this section has been extended, and to notify the submitting entity under paragraph (d) of this section that the fast-track procedures of this section are being terminated.

(2) The Director of the Division of Economic Analysis may submit to the Commission for its consideration any matter which has been delegated in paragraph (e)(1) of this section.

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

§ 5.3 Dormant contracts.

(a) *Definitions.* For purposes of this section:

(1) The term *dormant contract* means any commodity futures or option contract:

(i) In which no trading has occurred in any future or option expiration for a period of six complete calendar months; or

(ii) Which has been certified by a recognized futures exchange or a recognized derivatives transaction facility to the Commission to be a dormant contract market.

(2) [Reserved]

(b) *Listing of additional futures trading months or option expiration by certification.* A contract that has been listed for trading initially under the procedures of either §§ 5.1 or 5.2 that has become dormant may be relisted for trading additional months pursuant to the procedures of § 1.41(c) of this chapter by filing the bylaw, rule, regulation or resolution to list additional trading months or expirations with the Commission as specified in that section. Upon relisting, the contract must be identified by the recognized futures exchange as listed for trading by exchange certification.

(c) *Approval for listing of additional futures trading months or option expirations.* A contract that has been initially approved by the Commission under § 5.2 and that has become dormant may be relisted for trading additional months pursuant to the procedures of § 1.41(d) of this chapter by filing the bylaw, rule, regulation or resolution to list additional trading months or expirations with the Commission as specified in that section.

(1) Each such submission shall clearly designate the submission as filed pursuant to Commission Rule 5.3; and

(2) Include the information required to be submitted pursuant to § 5.3 or an economic justification for the listing of additional months or expirations in the dormant contract market, which shall include an explanation of those economic conditions which have changed subsequent to the time the contract became dormant and an explanation of how any new terms and conditions which are now being proposed, or which have been proposed for an option market's underlying futures contract market, would make it reasonable to expect that the futures or

option contract will be used on more than an occasional basis for hedging or price basing.

(d) *Exemptions.* No contract shall be considered dormant until the end of sixty (60) complete calendar months:

(1) Following initial listing; or

(2) Following Commission approval of the contract market bylaw, rule, regulation, or resolution to relist trading months submitted pursuant to paragraph (c) of this section.

Appendices C and D [Removed and Reserved]

c. Appendices C and D are removed and reserved.

PART 15—REPORTS—GENERAL PROVISIONS

6. The authority citation for Part 15 is revised to read as follows:

Authority: 7 U.S.C. 2, 4, 5, 6(c), 6a, 6c(a)–(d), 6f, 6g, 6i, 6k, 6m, 6n, 7, 9, 12a, 19 and 21.

7. Section 15.05 is amended by revising the heading and by adding paragraphs (e) through (h) to read as follows:

§ 15.05 Designation of agent for foreign brokers, customers of a foreign broker and foreign traders.

* * * * *

(e) Any derivatives transaction facility eligible under § 37.2(a)(2) of this chapter or recognized futures exchange that permits a foreign broker to intermediate transactions in futures or option contracts on the facility or exchange, or permits a foreign trader to effect transactions in futures or option contracts on the facility or exchange shall be deemed to be the agent of the foreign broker and any of its customers for whom the transactions were executed, or the foreign trader for purposes of accepting delivery and service of any communication issued by or on behalf of the Commission to the foreign broker, any of its customers or the foreign trader with respect to any futures or option contracts executed by the foreign broker or the foreign trader on the derivatives transaction facility eligible under § 37.2(a)(2) of this chapter or recognized futures exchange. Service or delivery of any communication issued by or on behalf of the Commission to a derivatives transaction facility eligible under § 37.2(a)(2) of this chapter or recognized futures exchange pursuant to such agency shall constitute valid and effective service upon the foreign broker, any of its customers, or the foreign trader. A derivatives transaction facility eligible under § 37.2(a)(2) of this chapter or recognized futures exchange which has been served with, or to which there has been delivered, a communication issued by or on behalf of the Commission to a foreign broker, any of its customers, or a foreign trader shall transmit the communication promptly and in a manner which is reasonable under the circumstances, or in a manner specified by the Commission in the communication, to the foreign broker, any of its customers or the foreign trader.

(f) It shall be unlawful for any derivatives transaction facility eligible under § 37.2(a)(2) of this chapter or recognized futures exchange to permit a foreign broker, any of its customers or a foreign trader to effect transactions in futures or option contracts unless the derivatives transaction facility eligible under § 37.2(a)(2) of this chapter or recognized futures exchange prior thereto informs the foreign broker, any of its customers or the foreign trader in any reasonable manner the derivatives transaction facility eligible under § 37.2(a)(2) of this chapter or recognized futures exchange deems to be appropriate, of the requirements of this section.

(g) The requirements of paragraphs (e) and (f) of this section shall not apply to any transactions in futures or option contracts if the foreign broker, any of its customers or the foreign trader has duly executed and maintains in effect a written agency agreement in compliance with this paragraph with a person domiciled in the United States and has provided a copy of the agreement to the derivatives transaction facility eligible under § 37.2(a)(2) of this chapter or recognized futures exchange prior to effecting any transactions in futures or option contracts on the derivatives transaction facility eligible under § 37.2(a)(2) of this chapter or recognized futures exchange. This agreement must authorize the person domiciled in the United States to serve as the agent of the foreign broker, any of its customers or the foreign trader for purposes of accepting delivery and service of all communications issued by or on behalf of the Commission to the foreign broker, any of its customers or the foreign trader and must provide an address in the United States where the agent will accept delivery and service of communications from the Commission. This agreement must be filed with the Commission by the derivatives transaction facility eligible under § 37.2(a)(2) of this chapter or recognized futures exchange prior to permitting the foreign broker, any of its customers or the foreign trader to effect any transactions in futures or option contracts. Unless otherwise specified by the Commission, the agreements required to be filed with the Commission shall be filed with the Secretary of the Commission at Three Lafayette Centre, 1155 21st Street, N.W., Washington, D.C. 20581. A foreign broker, any of its customers or a foreign trader shall notify the Commission immediately if the written agency agreement is terminated, revoked, or is otherwise no longer in effect. If the derivatives transaction facility eligible under § 37.2(a)(2) of this chapter or recognized futures exchange knows or should know that the agreement has expired, been terminated, or is no longer in effect, the derivatives transaction facility eligible under § 37.2(a)(2) of this chapter or recognized futures exchange shall notify the Secretary of the Commission immediately. If the written agency agreement expires, terminates, or is not in effect, the derivatives transaction facility eligible under § 37.2(a)(2) of this chapter or recognized futures exchange and the foreign broker, any of its customers or the foreign trader are subject to the provisions of paragraphs (e) and (f) of this section.

(h) The provisions of paragraphs (e), (f) and (g) of this section shall not apply to a derivatives transaction facility or recognized futures exchange on which all transactions in futures or option contracts of foreign brokers, their customers or foreign traders are executed through and the resulting transactions are maintained in accounts carried by a registered futures commission merchant or introducing broker subject to the provisions of Rules 15.05(a), (b), (c) and (d).

* * * * *

8. Part 36 is revised to read as follows:

PART 36—EXEMPTION OF TRANSACTIONS ON MULTILATERAL TRANSACTION EXECUTION FACILITIES

Sec.
36.1 Definitions. As used in this part:
36.2 Exemption.
36.3 Enforceability.

Authority: 7 U.S.C. 2, 6, 6c, and 12a.

§ 36.1 Definitions.

As used in this part:

(a) *Eligible participant* means and shall be limited to the parties or entities listed in § 35.1(b)(1) through (11) of this chapter; and

(b) *Multilateral transaction execution facility* means an electronic or non-electronic market or similar facility through which persons, for their own accounts or for the accounts of others,

enter into, agree to enter into or execute binding contracts, agreements or transactions by accepting bids or offers made by one person that are open to multiple persons who conduct business through such market or similar facility, but does not include:

(1) A facility whose participants individually negotiate (or have individually negotiated) with counterparties the material terms applicable to contracts, agreements, or transactions between them, including contracts, agreements, or transactions conducted on the facility, and which are subject to subsequent acceptance by the counterparties;

(2) Any electronic communications system on which the execution of a contract, agreement or transaction results from the content of bilateral communications exchanged between the parties and not by the interaction of multiple orders within a predetermined, non-discretionary automated trade matching algorithm; or

(3) Any facility on which only a single firm may participate as market maker and participants other than the market maker may not accept bids or offers of other non-market maker participants.

§ 36.2 Exemption.

A contract, agreement or transaction traded on a multilateral transaction execution facility as defined in § 36.1(b) is exempt from all provisions of the Act and any person or class of persons offering, entering into, rendering advice, or rendering other services with respect to such contract, agreement or transaction is exempt for such activity from all provisions of the Act (except in each case the provisions enumerated in § 36.3(a)) provided the following terms and conditions are met:

(a) Only eligible participants, either trading for their own account or through another eligible participant, have trading access to the multilateral transaction execution facility;

(b) The contract, agreement or transaction listed on or traded through the multilateral transaction execution facility is based upon:

(1) A debt obligation other than an exempt security under section 3 of the Securities Act of 1933 or section 3a(12) of the Securities Exchange Act of 1934;

(2) A foreign currency;

(3) An interest rate;

(4) A measure of credit risk or quality, including instruments known as ''total return swaps,'' ''credit swaps'' or ''credit spread swaps'';

(5) An occurrence, extent of an occurrence or contingency beyond the control of the counterparties to the transaction; or

(6) An economic or commercial index or measure which is beyond the control of the counterparties to the transaction, and is not based upon prices derived from trading in a directly corresponding underlying cash market and for which the related contract, agreement or transaction is cash settled;

(c) If cleared, the submission of such contracts, agreements or transactions for clearance and/or settlement must be to a clearing organization that is authorized under § 39.2 of this chapter: *Provided, however,* that nothing in this paragraph precludes:

(1) Arrangements or facilities between parties to such contracts, agreements or transactions that provide for netting of payment or delivery obligations resulting from such contracts, agreements, or transactions; or

(2) Arrangements or facilities among parties to such contracts, agreements or transactions, that provide for netting of payments or deliveries resulting from such contracts, agreements or transactions;

(d) The multilateral transaction execution facility on or through which such contracts, agreements or transactions are traded and the parties to, participants in, or intermediaries in such a facility that is exempt under this section are prohibited from claiming that the facility is regulated, recognized or approved by the Commission; and

(e) The facility:

(1) If an electronic system that also lists for trading products pursuant to parts 37 or 38 of this chapter, must provide notice to participants of the agreements, contracts or transactions traded on the facility pursuant to this part 36 and that such transactions are not subject to regulation under the Act; or

(2) If providing a physical trading environment, must provide that products trading pursuant to parts 37 or 38 of this chapter be traded in a location separate from, but which may adjoin, the location for products traded pursuant to this part 36.

(f) If the Commission determines by order, after notice and an opportunity for a hearing through submission of written data, views and arguments, that the facility serves as a significant source for the discovery of prices for an underlying commodity, the facility must on a daily basis disseminate publicly trading volume and price ranges and other trading data appropriate to that market as specified in the order.

(g) Any person or entity may apply to the Commission for exemption from any of the provisions of the Act (except section 2(a)(1)(B)) for other arrangements or facilities, on such terms and conditions as the Commission deems appropriate, including, but not limited to, the applicability of other regulatory regimes.

§ 36.3 Enforceability.

(a) Notwithstanding the exemption in § 36.2, sections 2(a)(1)(B), 4b, and 4o of the Act and § 32.9 of this chapter as adopted under section 4c(b) of the Act, and sections 6(c) and 9(a)(2) of the Act to the extent they prohibit 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, continue to apply to transactions and persons otherwise subject to those provisions.

(b) A party to a contract, agreement or transaction that is with a counterparty that is an eligible participant (or counterparty reasonably believed by such party at the time the contract, agreement or transaction was entered into to be an eligible participant) shall be exempt from any claim, counterclaim or affirmative defense by such counterparty under section 22(a)(1) of the Act or any other provision of the Act:

(1) That such contract, agreement or transaction is void, voidable or unenforceable, or

(2) To rescind, or recover any payment made in respect of, such contract, agreement or transaction, based solely on the failure of such party or such contract, agreement or transaction to comply with the terms or conditions of the exemption under this part.

9. Chapter I of 17 CFR is amended by adding new Part 37 as follows:

PART 37—EXEMPTION OF TRANSACTIONS ON A DERIVATIVES TRANSACTION FACILITY

Sec.

37.1 Scope and definitions.
37.2 Exemption.
37.3 General conditions for recognition as a derivatives transaction facilities.
37.4 Conditions for recognition as a derivatives transaction facility, compliance with core principles.
37.5 Additional conditions for recognition as a derivative transaction facility.
37.6 Information relating to transactions on derivative transaction facilities.
37.7 Procedures for recognition.
37.8 Enforceability.
37.9 Fraud in connection with part 37 transactions.
Appendix A to Part 37—Application Guidance.

Authority: 7 U.S.C. 2, 6, 6c, 6(c), 6(i) and 12a.

§ 37.1 Scope and definitions.

(a) *Scope.* (1) A board of trade operating as a recognized derivatives transaction facility and the products listed for trading thereon under this exemption shall be deemed to be subject to all of the provisions of the Act and Commission regulations thereunder which are applicable to a ''board of trade,'' ''board of trade licensed by the Commission,'' ''exchange,'' ''contract market,'' ''designated contract market,'' or ''contract market designated by the Commission'' as though those provisions were set forth in this section and included specific reference to contracts listed for trading by recognized derivatives transaction facilities pursuant to this section.

(2) The provisions of this section shall not apply to a commodity or a contract subject to the provisions of section 2(a)(1)(B) of the Act.

(b) *Definitions.* As used in this part:

(1) *Eligible participant* means, and shall be limited to, the parties or entities listed in § 35.1(b)(1) through (11) of this chapter, *Provided, however,* that notwithstanding the proviso of § 35.1(b)(10), a floor broker or floor trader that is a natural person or proprietorship shall be considered to be an eligible participant for transactions on a derivatives transaction facility recognized under § 37.7 if the floor broker or floor trader is registered in such a capacity under the Act and its trading obligations on the derivatives trading facility are guaranteed by a futures commission merchant.

(2) ''Eligible commercial participant'' means, and shall be limited to, a party or entity listed in §§ 35.1(b)(1), (b)(2), (b)(3), (b)(6) and (b)(8) of this chapter that in connection with its business, makes and takes delivery of the underlying commodity and regularly incurs risks in addition to price risk related to such commodity, is a dealer that regularly provides hedging, risk management or market-making services to the foregoing entities, or is a registered floor trader or floor broker trading for its own account, whose trading obligations are guaranteed by a futures commission merchant.

§ 37.2 Exemption.

Notwithstanding § 37.1(a)(1), a contract, agreement or transaction traded on a multilateral transaction execution facility as defined in § 36.1(b) of this chapter, the facility and the facility's operator are exempt from all provisions of the Act and from all Commission regulations thereunder for such activity, except for those provisions of the Act and Commission regulations which, as a condition of this exemption, are reserved in § 37.8(a), provided the following terms and conditions are met:

(a)(1) *Commercial-participant derivatives transaction facility.* Only eligible commercial participants trading for their own account have trading access to the derivatives transaction facility for contracts, agreements or transactions in any commodity except for those listed in section 1a(3) of the Act or an exempted security under section 3 of the Securities Act of 1933 or section 3(a)(12) of the Securities Exchange Act of 1934; or

(2)(i) *Eligible-participant derivatives transaction facility.* The contract, agreement or transaction listed on or traded through the multilateral transaction execution facility meets the requirements set forth in § 36.2(b) of this chapter or has been found by the Commission on a case-by-case determination to have a sufficiently liquid and deep cash market and a surveillance history based on actual trading experience to provide assurance that the contract is highly unlikely to be manipulated; and

(ii) *Non-eligible participants.* Participants that are not eligible participants as defined in § 37.1(b)(1) may have trading access only through:

(A) A registered futures commission merchant that operates in accordance with the provisions of § 1.17(a)(1)(ii) of this chapter and that carries such participant's account, including access directly through any credit filter on which the futures commission merchant affirmatively imposes credit standards; or

(B) A commodity trading advisor that operates in accordance with § 4.32 of this chapter, where the participant's account is carried by any registered futures commission merchant;

(b) The multilateral transaction execution facility through which the contract, agreement or transaction is entered into has been recognized by the Commission as a derivatives transaction facility pursuant to § 37.7;

(c) A multilateral transaction execution facility that applies to be, and is, a recognized derivatives transaction facility must comply with all of the conditions of this part 37 exemption and must disclose to participants transacting on or through its facility that transactions conducted on or through the facility are subject to the provisions of this part 37;

(d)(1) If intermediated, the transactions of eligible participants must be carried in accounts at a registered futures commission merchant;

(2) If cleared, the submission of such contracts, agreements or transactions for clearance and/or settlement must be to a clearinghouse that is recognized by the Commission under § 39.4 of this chapter. *Provided, however,* that nothing in this paragraph (d)(2) precludes:

(i) Arrangements or facilities between parties to such contracts, agreements or transactions that provide for netting of payment or delivery obligations resulting from such contracts, agreements, or transactions; or

(ii) Arrangements or facilities among parties to such contracts, agreements or transactions, that provide for netting of payments or deliveries resulting from such contracts, agreements or transactions; and

(e) The products if traded on an electronic system must be clearly identified as traded on a recognized derivatives transaction facility or if traded in a physical trading environment must be traded in a location separate from, but which may adjoin the location for, the trading of products pursuant to contract market designation, or to parts 36 and 38 of this chapter.

§ 37.3 General conditions for recognition as a derivatives transaction facility.

To be recognized as a derivatives transaction facility, the facility initially must have:

(a) Rules, which may be trading protocols, relating to trading on its facility, including, depending on the nature of the trading mechanism:

(1) Rules, which may be trading protocols, to deter trading abuses, and adequate power and capacity to detect, investigate and take action against violation of its trade rules or trading protocols including arrangements to obtain necessary information to perform the functions in this paragraph (a)(1), or

(2) Use of technology that provides participants with impartial access to transactions and captures information that is available for use in determining whether violations of its rules or trading protocols have occurred;

(b) Rules, which may be trading protocols, defining, or specifications detailing, the operation of the trading mechanism or electronic matching platform; and

(c) Rules, which may be trading protocols, detailing the financial framework applying to the transactions or ensuring the financial integrity of transactions entered into by, or through, its facilities.

§ 37.4 Conditions for recognition as a derivatives transaction facility, compliance with core principles.

To be recognized as a derivatives transaction facility, the facility, initially and on a continuing basis, must meet and adhere to the following core principles:

(a) *Enforcement.* Effectively monitor and enforce its rules, which may be trading protocols, including, if applicable, limitations on access.

(b) *Market oversight.* As appropriate to the market and the contracts traded:

(1) Monitor markets on a routine and nonroutine basis as necessary to ensure fair and orderly trading, and have, and where appropriate exercise, authority to maintain a fair and orderly market; or

(2) Provide information to the Commission as requested by the Commission to satisfy its obligations under the Act.

(c) *Operational information.* Disclose to regulators and to market participants, as appropriate, information concerning trading terms, trading protocols, contract terms and conditions, trading mechanisms, financial integrity arrangements or mechanisms, as well as other relevant information.

(d) *Transparency.* Provide to market participants on a fair, equitable and timely basis information regarding prices, bids and offers, and other information appropriate to the market and, as appropriate to the market, make available to the public with respect to actively traded products, to the extent applicable, information regarding daily opening and closing prices, price range, trading volume and other related market information.

(e) *Fitness.* Have appropriate fitness standards for members, operators or owners with greater than 10 percent interest or an affiliate of such an owner, members of the governing board, and those who make disciplinary determinations.

(f) *Recordkeeping.* Keep full books and records of all activities related to its business as a recognized derivatives transaction facility, including full information relating to data entry and trade details sufficient to reconstruct trading, 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.

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

§ 37.5 Additional conditions for recognition as a derivative transaction facility.

To be recognized as a derivatives transaction facility, initially and on a continuing basis, the facility must:

(a) *Products.* Notwithstanding the provisions of section 4(a)(1) of the Act or § 33.2 of this chapter, notify the Commission of the listing of new contracts for trading, posting of new product descriptions, terms and conditions or trading protocols or providing for a new system product functionality, by filing with the Commission at its Washington, D.C. headquarters, a submission labeled ''DTF Notice of Product Listing'' that includes the text of the contract's terms or conditions, product description, trading protocol or description of the system functionality or by electronic notification of the foregoing at the time traders or participants in the market are notified, but in no event later than the close of business on the business day preceding initial listing, posting or implementation of the trading protocol or system functionality;

(b) *Material modifications.* Notwithstanding the rule approval and filing requirements of section 5a(a)(12)(A) of the Act, notify the Commission prior to placing a material rule, term or condition or trading protocol into effect or amending a material rule, term or condition or trading protocol, by filing with the Commission at its Washington, D.C. headquarters a submission labeled, ''DTF Rule Notice'' which includes the text of the rule or rule amendment, term and condition or trading protocol (brackets must indicate words deleted and underscoring must indicate words added) or by electronic notification of the rule, term and condition or trading protocol to be placed into effect or to be changed, at the time and in the manner traders or participants in the market are notified, but in no event later than the close of business on the business day preceding implementation of the rule, term and condition or trading protocol. The derivatives transaction facility must maintain documentation regarding all changes to rules, terms and conditions or trading protocols;

(c) *Identify participants.* Keep a record in permanent form which shall show the true name; address; and principal occupation or business of any foreign trader executing transactions on the facility or exchange, as well as the name of any person guaranteeing such transactions or exercising any control over the trading of such foreign trader. *Provided, however,* this paragraph shall not apply to a derivatives transactions facility insofar as transactions in futures or option contracts of foreign traders are executed through and the resulting transactions are maintained in accounts carried by a registered futures commission merchant or introducing broker subject to § 1.37 of this chapter; and

(d) *Identify persons subject to fitness.* Upon request by the Commission, furnish to the Commission a current list of persons subject to the fitness requirements in accordance with § 37.4(e).

§ 37.6 Information relating to transactions on derivative transaction facilities.

(a) *Special calls for information from derivatives transaction facilities.* Upon special call by the Commission, a derivatives transaction facility shall provide to the Commission such information related to its business as a derivatives transaction facility, including information relating to data entry and trade details, in the form and manner and within the time as specified by the Commission in the special call.

(b) *Notification of communications.* (1) Upon receipt of any communications issued by or on behalf of the Commission to any person who resides or is domiciled outside of the United States, its territories, or possessions, relating to contracts, agreements, or transactions effected on or through a derivatives transaction facility, the derivatives transaction facility shall promptly notify such foreign person of, and transmit the communication to such foreign person, in a manner reasonable under the circumstances, or as specified by the Commission.

(2) If the Commission has reason to believe that a person has not complied with a communication issued by or on behalf of the Commission pursuant to paragraph (b)(1) of this section, the Commission in writing may direct the derivatives transaction facility on or through which the person is or has traded to deny that person further trading access either directly or, if applicable, through an intermediary or, as applicable, to permit that person access to trade for liquidation only.

(3) Any person that believes he or she is or may be adversely affected or aggrieved by action taken by the Commission under paragraph (b)(2) of this section, shall have the opportunity for a prompt hearing after the Commission acts pursuant to paragraph (b)(2) of this section under the procedures provided in § 21.03(g) of this chapter.

(c) *Special calls for information from futures commission merchants.* Upon special call by the Commission, each

person registered as a futures commission merchant that carries or has carried an account for a customer on a derivatives transaction facility shall provide information to the Commission concerning such accounts or related positions carried for the customer on that or other facilities or markets, in the form and manner and within the time specified by the Commission in the special call.

(d) *Special calls for information from participants.* Upon special call by the Commission, any person who enters into or has entered into a contract, agreement or transaction on a derivatives transaction facility eligible under § 37.2(a)(2) shall provide information to the Commission concerning such contracts, agreements, or transactions or related positions on other facilities or markets, in the form and manner and within the time specified by the Commission in the special call.

(e) *Delegation of authority.* The Commission hereby delegates, until the Commission orders otherwise, the authority set forth in paragraphs (a) through (d) of this section to the Directors of the Division of Economic Analysis and the Division of Trading and Markets to be exercised separately by each Director or by such other employee or employees as the Director may designate from time to time. The Director of the Divisions of Economic Analysis and Trading and Markets may submit to the Commission for its consideration any matter that has been delegated in this paragraph. Nothing in this paragraph prohibits the Commission, at its election, from exercising the authority delegated in this paragraph.

§ 37.7 Procedures for recognition.

(a) *Recognition by certification.* A board of trade, facility or entity that is designated under sections 4c, 5, 5a(a) or 6 of the Act as a contract market in at least one commodity which is not dormant within the meaning of § 5.2 of this chapter will be recognized by the Commission as a derivatives transaction facility upon receipt by the Commission at its Washington, D.C. headquarters of a copy of the derivatives transaction facility's rules, which may be trading protocols, and a certification by the board of trade, facility or entity that it meets the conditions for recognition under this part.

(b) *Recognition by application.* A board of trade, facility or entity shall be recognized or, as determined by the Commission, recognized upon conditions as a derivatives transaction facility thirty days after receipt by the Commission of an application for recognition as a derivatives transaction facility 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 37;

(3) The submission includes a copy of:

(i) The derivatives transaction facility's rules, which may be trading protocols;

(ii) Any agreements entered into or to be entered into between or among the facility, its operator or its participants, technical manuals and other guides or instructions for users of such facility, descriptions of any system test procedures, tests conducted or test results, and descriptions of the trading mechanism or algorithm used or to be used by such facility, to the extent such documentation was otherwise prepared; and

(iii) To the extent that compliance with the conditions of recognition is not self-evident, a brief explanation of how the rules or trading protocols satisfy each of the conditions for recognition under §§ 37.3 and 37.4;

(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 provides guidance to applicants on how the conditions for recognition enumerated in §§ 37.3 and 37.4 could be satisfied.

(c) *Termination of part 37 review.* During the thirty-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 derivatives transaction facility 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, until it orders otherwise, to the Directors of the Division of Trading and Markets and the Division of Economic Analysis or their delegatees, with the concurrence of the General Counsel or the General Counsel's delegatee, authority to notify the entity seeking recognition under paragraph (b) of this section that review under those procedures is being terminated or to recognize the entity as a derivatives transaction facility upon conditions.

(2) The Directors of the Division of Trading and Markets or the Division of Economic Analysis 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 and products.* (1) An entity seeking recognition as a derivatives transaction facility may request that the Commission approve any or all of its rules and subsequent amendments thereto, including both operational rules and the terms or conditions of products listed for trading on the facility, at the time of recognition or thereafter, under section 5a(a)(12) of the Act and §§ 1.41(d) and 5.2 of this chapter, as applicable. A derivatives transaction facility may label a product in its rules as, ''Listed for trading pursuant to Commission approval,'' if the product's terms or conditions have been approved by the Commission.

(2) An entity seeking recognition as a derivatives transaction facility may request that the Commission consider under the provisions of section 15 of the Act any of the entity's rules or policies, including both operational rules and the terms or conditions of products listed for trading, at the time of recognition or thereafter.

(f) *Request for withdrawal of application for recognition or withdrawal of recognition.* A recognized derivatives transaction facility may withdraw an application to be a recognized derivatives transaction facility or, once recognized, may withdraw from Commission recognition by filing with the Commission at its Washington, D.C., 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 facility was recognized by the Commission.

§ 37.8 Enforceability.

(a) Notwithstanding the exemption in § 37.2, the following provisions of the Act and Commission regulations thereunder are reserved, and shall continue to apply: sections 1a, 2(a)(1), 4, 4b, 4c(a) as applicable to the market, 4c(b), 4g, 4i, 4o, 5(6), 5(7), 5a(a)(1), 5a(a)(2), 5a(a)(8), 5a(a)(16), 5a(a)(17), 5a(b), 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(9), 8c(a) as applicable to the market, 9(a)(2), 9(a)(3), 9(f), 14, 15, 20 and 22 of the Act and §§ 1.3, 1.31, 1.41, 5.2, 15.05 as applicable to the market, § 33.10, this part 37 and part 190 of this chapter; and for derivatives transaction facilities eligible under § 37.2(a)(2), in addition to the foregoing, the rule disapproval procedures of section 5a(a)(12) of the Act, section 9(a)(1) of the Act, and sections 8c(b), 8c(c) and 8c(d) of the Act and parts 15 through 21 of this chapter as applicable to the market.

(b) For purposes of section 22(a) of the Act, a party to a contract, agreement or transaction is exempt from a claim that the contract, agreement or transaction is void, voidable, subject to rescission or otherwise invalidated or rendered unenforceable solely for failure of the parties to a contract, agreement or transaction, or the contract, agreement or transaction itself, to comply with the terms and conditions for the exemption under this part or as a result of:

(1) A violation by the recognized derivatives transaction facility of the provisions of this part 37; or

(2) Any Commission proceeding to disapprove a rule, term or condition under section 5a(a)(12) of the Act, to alter or supplement a rule, term or condition under section 8a(7) of the Act, to declare an emergency under section 8a(9) of the Act, or any other proceeding the effect of which is to disapprove, alter, supplement, or require a recognized derivatives transaction facility to adopt a specific term or condition, trading rule or procedure, or to take or refrain from taking a specific action.

§ 37.9 Fraud in connection with part 37 transactions.

It shall be unlawful for any person, directly or indirectly, in or in connection with an offer to enter into, the entry into, the confirmation of the execution of, or the maintenance of any transaction entered into pursuant to this part—

(1) To cheat or defraud or attempt to cheat or defraud any person;

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

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

Appendix A to Part 37—Application Guidance

This appendix provides guidance to applicants for recognition as derivatives transaction facilities under §§ 37.3 and 37.4. Addressing the issues and questions set forth in this appendix would help the Commission in its consideration of whether the application has met the conditions for recognition. To the extent that compliance with, or satisfaction of, a core principle is not self-explanatory from the face of the derivatives transaction facilities rules or terms, the application should include an explanation or other form of documentation demonstrating that the applicant meets the conditions for recognition.

Core Principle 1: Enforcement: Effectively monitor and enforce its rules, which may be trading protocols, including, if applicable, limitations on access.

(a) A derivatives transaction facility should have arrangements and resources and authority for effectively and affirmatively enforcing its rules, including the authority and ability to collect or capture information and documents on both a routine and non-routine basis and to investigate effectively possible rule violations.

(b) This should include the authority and ability to discipline, and limit or suspend a member's or participant's activities and/or the authority and ability to terminate a member's or participant's activities or access pursuant to clear and fair standards.

Core Principle 2: Market Oversight. As appropriate to the market and the contracts traded: (1) Monitor markets on a routine and nonroutine basis as necessary to ensure fair and orderly trading, and have, and where appropriate exercise, authority to maintain a fair and orderly market; or (2) Provide information to the Commission as requested by the Commission to satisfy its obligations under the Act.

(a) Arrangements and resources for effective market surveillance programs should facilitate, on both a routine and nonroutine basis, direct supervision of the market. Appropriate objective testing and review of any automated systems should occur initially and periodically to ensure proper system functioning, adequate capacity and security. The analysis of data collected should be suitable for the type of information collected and should occur in a timely fashion. A derivatives transaction facility should have the authority to collect the information and documents necessary to reconstruct trading for appropriate market analysis as it carries out its market surveillance programs. The derivatives transaction facility also should have the authority to intervene as necessary to maintain an open and competitive market. In carrying out this responsibility, the facility should address access to, and use of, material non-public information by members, owners or operators, participants or facility employees.

(b) Alternatively, and as appropriate to the market, a derivatives transaction facility may choose to satisfy Core Principle 2 by providing information to the Commission as requested by the Commission to satisfy its obligations under the Act. The derivatives transaction facility should have the authority to collect or capture and retrieve all necessary information.

(c) The Commission will collect reporting data from eligible participants trading in a derivatives transaction facility eligible under § 37.2(a)(2) only upon Special Call as provided in § 37.6(d).

Core Principle 3: Operational Information: Disclose to regulators and to market participants, as appropriate, information concerning trading terms, trading protocols, contract terms and conditions, trading mechanisms, financial integrity arrangements or mechanisms, as well as other relevant information.

A derivatives transaction facility should have arrangements and resources for the disclosure and explanation of trading terms, trading protocols, contract terms and conditions, trading mechanisms, system functioning, system capacity, system security, system testing and review, financial integrity arrangements or mechanisms. The facility must also disclose any limitations of liability (which may not include limitations of liability for violations of the Act or Commission rules, fraud, or wanton or willful misconduct. Such information may be made publicly available through the operation of a website by the derivatives transaction facility.

Core Principle 4: Transparency: Provide to market participants on a fair, equitable and timely basis information regarding prices, bids and offers, and other information appropriate to the market and, as appropriate to the market, make available to the public with respect to actively traded products, to the extent applicable, information regarding daily opening and closing prices, price range, trading volume and other related market information.

All market participants should have information regarding prices, bids and offers, or other information appropriate to the market readily available on a fair and equitable basis. The derivatives transaction facility should provide to the public information regarding daily opening and closing prices, price range, trading volume, open interest and other related market information for actively traded products. Provision of information could be through such means as provision of the information to a financial information service or by placement of the information on a facility's web site.

Core Principle 5: Fitness: Have appropriate fitness standards for members, operators or

owners with greater than 10 percent interest or an affiliate of such an owner, members of the governing board, and those who make disciplinary determinations.

A derivatives transaction facility should have appropriate eligibility criteria for the categories of persons set forth in the Core Principle which would include standards for fitness and for the collection and verification of information supporting compliance with such standards. Minimum standards of fitness are those bases for refusal to register a person under section 8a(2) of the Act. or a history of serious disciplinary offenses, such as those which would be disqualifying under § 1.63 of this chapter. A demonstration of the fitness of the applicant's members, operators or owners may include providing the Commission with registration information for such persons, certification to the fitness of such persons, an affidavit of such persons' fitness by the facility's Counsel or other information substantiating the fitness of such persons.

Core Principle 6: Recordkeeping: Keep full books and records of all activities related to its business as a recognized derivatives transaction facility, including full information relating to data entry and trade details sufficient to reconstruct trading, 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.

Commission rule 1.31 constitutes the acceptable practice regarding the form and manner for keeping records.

Core Principle 7: Competition: Operate in a manner consistent with the public interest to be protected by the antitrust laws.

An entity seeking recognition as a derivatives transaction facility may request that the Commission consider under the provisions of section 15 of the Act any of the entity's rules, which may be trading protocols or policies, and including both operational rules and the terms or conditions of products listed for trading, at the time of recognition or thereafter. The Commission intends to apply Section 15 of the Act to its consideration of issues under the Competition Core Principle in a manner consistent with that previously applied to contract markets.

10. Chapter I of 17 CFR is amended by adding new Part 38 as follows:

PART 38—EXEMPTION OF TRANSACTIONS ON A RECOGNIZED FUTURES EXCHANGE

Sec.
38.1 Scope.
38.2 Exemption.
38.3 General conditions for recognition as a recognized futures exchange.
38.4 Conditions for recognition as a recognized futures exchange, compliance with core principles.
38.5 Procedures for recognition.
38.6 Enforceability
38.7 Fraud in connection with part 38 transactions.
Appendix A to Part 38—Guidance for Applicants and Acceptable Practices

Authority: 7 U.S.C. 2, 6, 6c, and 12a.

§ 38.1 Scope.

(a) Except for commodities subject to paragraph (c) of this section, the provisions of the exemption in § 38.2 shall apply to every board of trade that has been designated as a contract market in a commodity under section 6 of the Act. *Provided, however*, nothing in this provision affects the eligibility of designated contract markets for exemption under parts 36 or 37 of this chapter.

(b) A board of trade operating as a recognized futures exchange and the products listed for trading thereon under this exemption shall be deemed to be subject to all of the provisions of the Act and Commission regulations thereunder which are applicable to a ''board of trade,'' ''board of trade licensed by the Commission,'' ''exchange,'' ''contract market,'' ''designated contract market,'' or ''contract market designated by the Commission'' as though those provisions were set forth in this section and included specific reference to contracts listed for trading by recognized futures exchanges pursuant to this section.

(c) The provisions of this section shall not apply to a commodity or a contract subject to the provisions of section 2(a)(1)(B) of the Act.

§ 38.2 Exemption.

Notwithstanding § 38.1(b), a contract, agreement or transaction traded on a multilateral transaction execution facility as defined in § 36.1(b) of this chapter, the facility and the facility's operator is exempt from all provisions of the Act and from all Commission regulations thereunder for such activity, except for those provisions of the Act and Commission regulations which, as a condition of this exemption, are reserved in § 38.6(a), provided the following terms and conditions are met:

(a) The multilateral transaction execution facility on which the contract, agreement or transaction is entered into has been recognized by the Commission as a recognized futures exchange pursuant to § 38.5;

(b) A multilateral transaction execution facility that applies to be, and is, a recognized futures exchange must comply with all of the conditions of this part 38 exemption and must disclose to participants transacting on or through its facilities that transactions conducted on or through the facility are subject to the provisions of part 38;

(c)(1) If intermediated, the transactions of participants must be carried in accounts at a registered futures commission merchant;

(2) If cleared, the submission of such contracts, agreements or transactions for clearance and/or settlement must be to a clearinghouse which is recognized by the Commission under part 39 of this chapter. *Provided, however*, that nothing in this paragraph precludes:

(i) Arrangements or facilities between parties to such contracts, agreements or transactions that provide for netting of payment or delivery obligations resulting from such agreements; or

(ii) Arrangements or facilities among parties to such contracts, agreements or transactions, that provide for netting of payments or deliveries resulting from such agreements; and

(d) The products if traded on an electronic system must be clearly identified as traded on a recognized futures exchange or if traded in a physical trading environment must be traded in a location separate from, but which may adjoin the location for, the trading of products pursuant to parts 36 and 37 of this chapter;

§ 38.3 General conditions for recognition as a recognized futures exchange.

To be recognized as a recognized futures exchange, the exchange must demonstrate initially that it has:

(a) A clear framework for conducting programs of market surveillance, compliance, and enforcement, including having procedures in place to make use of collected data for real-time monitoring and for post-event audit and compliance purposes to prevent market manipulation;

(b) Rules relating to trading on the exchange, including rules to deter trading abuses, and adequate power and capacity to detect, investigate and take action against violations of its trading rules, and a dedicated regulatory department or delegation of that function to an appropriate entity;

(c) Rules defining, or specifications detailing, the manner of operation of the trading mechanism or electronic matching platform and a trading mechanism or electronic matching platform that performs as articulated in the operational rules or specifications;

(d) A clear framework for ensuring the financial integrity of transactions entered into by or through the exchange;

(e) Established procedures for impartial disciplinary committee(s) or other similar mechanisms empowered to discipline, suspend, and expel members, or to deny access to participants or, if provided for, discipline participants; and

(f) Arrangements to obtain necessary information to perform the functions in this section, including the capacity and arrangements to share financial and surveillance information with other derivative exchanges, both domestic and international, and a mechanism to provide to the public ready access to its rules and regulations.

§ 38.4 Conditions for recognition as a recognized futures exchange, compliance with core principles.

To be recognized as a futures exchange, the exchange initially, and on a continuing basis, must meet and adhere to the following core principles:

(a) *Rule enforcement.* Effectively monitor and enforce its rules.

(b) *Products.* List contracts for trading that are not readily susceptible to manipulation.

(c) *Position monitoring and reporting.* Monitor markets on a routine and nonroutine basis as necessary to prevent manipulation, price distortion, and disruptions of the delivery or cash settlement process.

(d) *Position limits.* Adopt position limits on trading where necessary and appropriate to lessen the threat of market manipulation or congestion during delivery months.

(e) *Emergency authority.* Exercise authority to intervene to maintain fair and orderly trading, including, where applicable, authority to liquidate or transfer open positions, to require the suspension or curtailment of trading, and to require the posting of additional margin.

(f) *Public information.* Make information concerning the contract terms and conditions and the trading mechanism, as well as other relevant information, readily available to market authorities, users and the public.

(g) *Transparency.* Provide market participants on a fair, equitable and timely basis information regarding, as appropriate to the market, prices, bids and offers, and other appropriate information, and make available to the public information regarding daily opening and closing prices, price ranges, trading volume, open interest and other related market information.

(h) *Trading system.* Provide a competitive, open and efficient market.

(i) *Audit trail.* Have procedures to ensure the recording of full data entry and trade details sufficient to reconstruct trading, the quality of the data captured, and the safe storage of such information, and have systems to enable information to be used in assisting in detecting and deterring customer and market abuse.

(j) *Financial standards.* Have, monitor, and enforce rules regarding the financial integrity of the transactions that have been executed on the exchange and, where intermediaries are permitted, rules addressing the financial integrity of the intermediary and the protection of customer funds, as appropriate, and a program to enforce those requirements.

(k) *Customer protection.* Have, monitor and enforce rules for customer protection.

(l) *Dispute resolution.* Provide for alternative dispute resolution mechanisms appropriate to the nature of the market.

(m) *Governance.* Have fitness standards for members, owners or operators with greater than ten percent interest or an affiliate of such an owner, members of the governing board, and those who make disciplinary determinations. The recognized futures exchange must have a means to address conflicts of interest in making decisions and access to, and use of, material non-public information by the foregoing persons and by exchange employees. For mutually owned futures exchanges, the composition of the governing board must reflect market participants.

(n) *Recordkeeping.* Keep full books and records of all activities related to its business as a recognized futures exchange 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.

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

§ 38. 5 Procedures for recognition.

(a) *Recognition by prior designation.* A board of trade, facility or entity that is designated under sections 4c, 5, 5a(a) or 6 of the Act as a contract market on February 12, 2001 in at least one commodity which is not dormant within the meaning of § 5.3 of this chapter is recognized by the Commission as a recognized futures exchange and each of the contracts traded thereon that has been designated by the Commission as a designated contract market in a commodity may be labeled in the recognized futures exchange's rules as listed for trading pursuant to Commission approval.

(b) *Recognition by application.* A board of trade, facility or entity shall be recognized or, as determined by the Commission, recognized upon conditions as a recognized futures exchange 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 38;

(3) The submission includes a copy of the applicant's rules and, to the extent that compliance with the conditions for recognition is not self-evident, a brief explanation of how the rules satisfy each of the conditions for registration under §§ 38.3 and 38.4;

(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 provides guidance to applicants on how the conditions for recognition enumerated in §§ 38.3 and 38.4 could be satisfied.

(c) *Termination of part 38 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 futures exchange 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, until it orders otherwise, to the Directors of the Division of Trading and Markets and the Division of Economic Analysis or their delegatees, with the concurrence of the General Counsel or the General Counsel's delegatee, authority to notify the entity seeking recognition under paragraph (b) of this section that review under those procedures is being

terminated or to recognize the entity as a recognized futures exchange upon conditions.

(2) The Directors of the Division of Trading and Markets or the Division of Economic Analysis 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 and products.* (1) An entity seeking recognition as a recognized futures exchange may request that the Commission approve any or all of its rules and subsequent amendments thereto, including both operational rules and the terms or conditions of products listed for trading on the exchange, at the time of recognition or thereafter, under section 5a(a)(12) of the Act and §§ 1.41 and 5.2 of this chapter, as applicable. A product the terms or conditions of which have been approved by the Commission may be labeled in its rules as listed for trading pursuant to Commission approval. In addition, rules of the recognized futures exchange not submitted pursuant to § 38.5(b)(3) shall be submitted to the Commission pursuant to § 1.41.

(2) An entity seeking recognition as a recognized futures exchange may request that the Commission consider under the provisions of section 15 of the Act any of the entity's rules or policies, including both operational rules and the terms or conditions of products listed for trading, at the time of recognition or thereafter.

(f) *Request for withdrawal of application for recognition or withdrawal of recognition.* An entity may withdraw an application to be a recognized futures exchange or once recognized, may withdraw from Commission recognition by filing with the Commission at its Washington, D.C. 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 exchange was recognized by the Commission.

§ 38.6 Enforceability.

(a) Notwithstanding the exemption in § 38.2, the following provisions of the Act and the Commission's regulations thereunder are reserved and shall continue to apply, as applicable: sections 1a, 2(a)(1), 4, 4a, 4b, 4c, 4g, 4i, 4o, 5(6), 5(7), 5a(a)(1), 5a(a)(2), 5a(a)(8), the rule disapproval procedures of 5a(a)(12), 5a(a)(16), 5a(a)(17), 5a(b), 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, 1.31, 1.38, 1.41, 33.10, part 5, part 9, parts 15 through 21, part 38 and part 190 of this chapter.

(b) For purposes of section 22(a) of the Act, a party to a contract, agreement or transaction is exempt from a claim that the contract, agreement or transaction is void, voidable, subject to rescission or otherwise invalidated or rendered unenforceable as a result of:

(1) A violation by the recognized futures exchange of the provisions of this part 38; or

(2) Any Commission proceeding to disapprove a rule, term or condition under section 5a(a)(12) of the Act, to alter or supplement a rule, term or condition under section 8a(7) of the Act, to declare an emergency under section 8a(9) of the Act, or any other proceeding the effect of which is to disapprove, alter, supplement, or require a recognized futures exchange to adopt a specific term or condition, trading rule or procedure, or to take or refrain from taking a specific action.

§ 38.7 Fraud in connection with part 38 transactions.

It shall be unlawful for any person, directly or indirectly, in or in connection with an offer to enter into, the entry into, the confirmation of the execution of, or the maintenance of any transaction entered pursuant to this part:

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

(b) Willfully to make or cause to be made to any 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 person by any means whatsoever.

Appendix A to Part 38—Guidance for Applicants and Acceptable Practices

1. This appendix provides guidance and acceptable practices for the core principles found in Part 38. Guidance to applicants for recognition as recognized futures exchanges under §§ 38.3 and 38.4 is offered under subsection (a) following a core principle. This appendix is only illustrative of the types of matters an applicant may address, as applicable, and is not intended to be a mandatory checklist. Addressing the issues and questions set forth in this appendix would help the Commission in its consideration of whether the application has met the conditions for recognition. To the extent that compliance with, or satisfaction of, a core principle is not self-explanatory from the face of the recognized futures exchange's rules or terms, the application should include an explanation or other form of documentation demonstrating that the applicant meets the conditions for recognition.

2. Acceptable practices meeting the requirements of the core principles are set forth in subsection (b). Recognized futures exchanges that follow specific practices outlined under subsection (b) for any core principle in this appendix will meet the applicable core principle. Except where otherwise provided, subsection (b) is for illustrative purposes only, and does not state the exclusive means for satisfying a core principle.

Core Principle 1: Rule Enforcement: Effectively monitor and enforce its rules.

(a) *Application Guidance.*

(1) A recognized futures exchange should have arrangements and resources for effective trade practice surveillance programs, with the authority to collect information and documents on both a routine and non-routine basis including the examination of books and records kept by members/participants of the exchange. The arrangements and resources should facilitate the direct supervision of the market and the analysis of data collected.

(2) A recognized futures exchange should have arrangements, resources and authority for effective rule enforcement. The Commission believes that this should include the authority and ability to discipline and limit or suspend a member's or participant's activities as well as the authority and ability to terminate a member's or participant's activities pursuant to clear and fair standards.

(b) *Acceptable Practices.* An effective trade practice surveillance program should include:

(1) Maintenance of data reflecting the details of each transaction executed on an RFE;

(2) Electronic analysis of this data routinely to detect potential trading violations;

(3) Appropriate and thorough investigative analysis of these and other potential trading violations brought to its attention; and

(4) Prompt and effective disciplinary action for any violation that is found to have been committed. The Commission believes that the latter element should include the authority and ability to discipline and limit or suspend a member's or participant's activities pursuant to clear and fair standards. *See, e.g.,* 17 CFR part 8.

Core Principle 2: Products: List contracts for trading that are not readily susceptible to manipulation.

(a) *Application Guidance.* Applicants should submit their initial product for listing for Commission approval under § 5.2 and Part 5, Appendix A, of this chapter. Subsequent products may be listed for trading by self-certification under § 5.1 of this chapter.

(b) *Acceptable Practices.*

Guideline No. 1, 17 CFR Part 5, Appendix A may be used as guidance in meeting this core principle.

Core Principle 3: Position monitoring and reporting: Monitor markets on a routine and nonroutine basis as necessary to prevent manipulation, price distortion, and disruptions of the delivery or cash settlement process.

(a) *Application Guidance.* [Reserved]

(b) *Acceptable Practices.*

(1) An acceptable program for monitoring markets will generally involve the collection of various market data, including information on traders' market activity. Those data should be evaluated on an ongoing basis in order to make an appropriate regulatory response to potential market disruptions or abusive practices.

(2) The recognized futures exchange should collect data in order to assess whether the market price is responding to the forces of supply and demand. Appropriate data usually include various fundamental data about the underlying commodity, its supply, its demand, and its movement through marketing channels. Especially important are data related to the size and ownership of deliverable supplies—the existing supply and the future or potential supply, and to the pricing of the deliverable commodity relative to the futures price and relative to similar, but nondeliverable, kinds of the commodity. For cash-settled markets, it is more appropriate to pay attention to the availability and pricing of the commodity making up the index to which the market will be settled, as well as monitoring the continued suitability of the methodology for deriving the index.

(3) To assess traders' activity and potential power in a market, at a minimum, every exchange should have routine access to the positions and trading done by the members of its clearing facility. Although clearing member data may be sufficient for some exchanges, an effective surveillance program for exchanges with substantial numbers of customers trading through intermediaries should employ a much more comprehensive large-trader reporting system (LTRS). The Commission operates an industry-wide LTRS. As an alternative to having its own LTRS or contracting out for such a system, exchanges may find it more efficient to use information available from the Commission's LTRS data for position monitoring.

Core Principle 4: Position Limits. Adopt position limits on trading where necessary and appropriate to lessen the threat of market manipulation or congestion during delivery months.

(a) *Application Guidance.* [Reserved]

(b) *Acceptable Practices.*

(1) In order to diminish potential problems arising from excessively large speculative positions, the Commission sets limits on traders' positions for certain commodities. These position limits specifically exempt bona fide hedging, permit other exemptions, and set limits differently by markets, by futures or delivery months, or by time periods. For purposes of evaluating an exchange speculative-limit program, the Commission considers the specified limit levels, aggregation policies, types of exemptions allowed, methods for monitoring compliance with the specified levels, and procedures for enforcement to deal with violations.

(2) In general, position limits are not necessary for markets where the threat of excessive speculation or manipulation is very low. Thus, exchanges do not need to set position-limit levels for futures markets in major foreign currencies and in certain financial futures having very liquid and deep underlying cash markets. Where speculative limits are appropriate, acceptable speculative-limit levels typically are set in terms of a trader's combined position in the futures contract plus its position in the option contract (on a delta-adjusted basis).

(3) Spot-month levels for physical-delivery markets should be based upon an analysis of deliverable supplies and the history of spot-month liquidations. Spot-month limits for physical-delivery markets are appropriately set at no more than 25 percent of the estimated deliverable supply. For cash-settled markets, spot-month position limits may be necessary if the underlying cash market is small or illiquid such that traders can disrupt the cash market or otherwise influence the cash-settlement price to profit on a futures position. In these cases, the limit should be set at a level that minimizes the potential for manipulation or distortion of the futures contract's or the underlying commodity's price. Markets may elect not to provide all-months-combined and non-spot month limits.

(4) An exchange may provide for position accountability provisions in lieu of position limits for contracts on financial instruments, intangible commodities, or certain tangible commodities. Markets appropriate for position accountability rules include those with large open-interest, high daily trading volumes and liquid cash markets.

(5) Exchanges must have aggregation rules that apply to those accounts under common control, those with common ownership, *i.e.,* where there is a 10 percent or greater financial interest, and those traded according to an expressed or implied agreement. Exchanges will be permitted to set more stringent aggregation policies. For example, one major exchange adopted a policy of automatically aggregating members of the same household, unless they were granted a specific waiver. Exchanges may grant exemptions to their position limits for bona fide hedging (as defined in Commission Rule 1.3(z)) and may grant exemptions for reduced risk positions, such as spreads, straddles and arbitrage positions.

(6) Exchanges must establish a program for effective monitoring and enforcement of these limits. One acceptable enforcement mechanism is a program whereby traders apply for these exemptions by the exchange and are granted a position level higher than the applicable speculative limit. The position levels granted under hedge exemptions are based upon the trader's commercial activity in related markets. Exchanges may allow a brief grace period where a qualifying trader may exceed speculative limits or an existing exemption level pending the submission and approval of appropriate justification. An exchange should consider whether it wants to restrict exemptions during the last several days of trading in a delivery month. Acceptable procedures for obtaining and granting exemptions include a requirement that the exchange approve a specific maximum higher level.

(7) Exchanges with many markets with large numbers of traders should have an automated means of detecting traders' violations of speculative limits or exemptions. Exchanges should monitor the continuing appropriateness of approved exemptions by periodically reviewing each trader's basis for exemption or requiring a reapplication.

(8) Finally, an acceptable speculative limit program must have specific policies for taking regulatory action once a violation of a position limit or exemption is detected. The exchange policy will need to consider appropriate actions where the violation is by a non-member and should address traders carrying accounts through more than one intermediary.

(9) A violation of exchange position limits that have been approved by the Commission is also a violation of section 4a(e) of the Act.

Core Principle 5: Emergency Authority: Exercise authority to intervene to maintain fair and orderly trading, including, where applicable, authority to liquidate or transfer open positions, to require the suspension or curtailment of trading, and to require the posting of additional margin.

(a) *Application Guidance.*

A recognized futures exchange should have clear procedures and guidelines for exchange decision-making regarding emergency intervention in the market, including procedures and guidelines to carry out such decision-making without a conflict of interests. An exchange should also have the authority to intervene as necessary to maintain markets with fair and orderly trading as well as procedures for carrying out the intervention. The Commission believes that a recognized futures exchange should also have procedures and guidelines for the notification of the Commission of the exercise of regulatory emergency authority, as well as procedures and guidelines to prevent conflicts of interest, for the documentation of the exchange's decision-making process and for the reasons for use of its emergency action authority.

(b) *Acceptable Practices.*

As is necessary to address perceived market threats, the exchange, among other things, should be able to impose position limits in particular in the delivery month, impose or modify price limits, modify circuit breakers, call for additional margin either from customers or clearing members, order the liquidation or transfer of open positions, order the fixing of a settlement price, order the reduction in positions, extend or shorten the expiration date or the trading hours, suspend or curtail trading on the market, order the transfer of customer contracts and the margin for such contracts from one member of the exchange to another or alter the delivery terms or conditions.

Core Principle 6: Public Information: Make information concerning the contract terms and conditions and the trading mechanism, as well as other relevant information, readily available to market authorities, users and the public.

(a) *Application Guidance.*

A recognized futures exchange should have arrangements and resources for the

disclosure of contract terms and conditions and trading mechanisms to the Commission, users and the public. Procedures should also include the provision of information on listing new products, rule amendments or other changes to previously disclosed information to the Commission, users and the public.

(b) *Acceptable Practices.* [Reserved]

Core Principle 7: Transparency: Provide market participants on a fair, equitable and timely basis information regarding, as appropriate to the market, prices, bids and offers, and other appropriate information, and make available to the public information regarding daily opening and closing prices, price ranges, trading volume, open interest and other related market information.

(a) *Application Guidance.* [Reserved].

(b) *Acceptable Practices.* [Reserved]

Core Principle 8: Trading System: Provide a competitive, open and efficient market.

(a) *Application Guidance.*

(1) Appropriate objective testing and review of any automated systems should occur initially and periodically to ensure proper system functioning, adequate capacity and security. A recognized futures exchange's analysis of its automated system should address appropriate principles for the oversight of automated systems, ensuring proper system function, adequate capacity and security. The Commission believes that the guidelines issued by the International Organization of Securities Commissions (IOSCO) in 1990 (which have been referred to as the ''Principles for Screen-Based Trading Systems''), subsequently adopted by the Commission on November 21, 1990 (55 FR 48670), are appropriate guidelines for a recognized futures exchange to apply to electronic trading systems. Any program of objective testing and review of the system should be performed by a qualified independent professional. The Commission believes that information gathered by analysis, oversight or any program of objective testing and review of any automated systems regarding system functioning, capacity and security should be made available to the Commission and the public.

(2) A recognized futures exchange that determines to allow block trading should have rules which:

(i) Define the block based upon the customary size of large positions in the cash and derivatives market,

(ii) Restrict access to block trading to eligible participants,

(iii) Provide a mechanism for ensuring that the block's price will be fair and reasonable, and

(iv) provide for transparency of the trade by requiring that it be reported for clearing within a reasonable period of time and that it be identified separately in the price reporting system.

(b) *Acceptable Practices.*

A professional that is a certified member of the Informational Systems Audit and Control Association experienced in the industry would be an example of an acceptable party to carry out such testing and review.

Core Principle 9: Audit Trail: Have procedures to ensure the recording of full data entry and trade details sufficient to reconstruct trading, the quality of the data captured, and the safe storage of such information, and have systems to enable information to be used in assisting in detecting and deterring customer and market abuse.

(a) *Application Guidance.*

A recognized futures exchange should have arrangements and resources for recording of full data entry and trade details sufficient to reconstruct trading and the safe storage of audit trail data systems enabling information to be used in combating customer and market abuse.

(b) *Acceptable Practices.*

(1) The goal of an audit trail is to detect and deter customer and market abuse. An effective exchange audit trail should capture and retain sufficient trade-related information to permit exchange staff to detect trading abuses and to reconstruct all transactions. An audit trail should include specialized electronic surveillance programs that would identify potentially abusive trades and trade patterns, including for instance, withholding or disclosing customer orders, trading ahead, and preferential allocation. An acceptable audit trail must be able to track a customer order from time of receipt through fill allocation. The exchange must create and maintain an electronic transaction history database that contains information with respect to transactions affected on the recognized futures exchange.

(2) An acceptable audit trail, therefore, should include the following: original source documents, transaction history, electronic analysis capability, and safe storage capability. A registered futures exchange whose audit trail satisfies the following acceptable practices would satisfy Core Principle 9.

(i) *Original Source Documents.* Original source documents include unalterable, sequentially identified records on which trade execution information is originally recorded, whether recorded manually or electronically. For each customer order, such records reflect the terms of the order, an account identifier that relates back to the account(s) owner(s), and the time of order entry. For floor-based exchanges, the time of report of execution of the order should also be captured.

(ii) *Transaction History.* A transaction history which consists of an electronic history of each transaction, including:

(A) All data that are input into the trade entry or matching system for the transaction to match and clear;

(B) Whether the trade was for a customer or proprietary account;

(C) Timing and sequencing data adequate to reconstruct trading; and

(D) The identification of each account to which fills are allocated.

(iii) *Eectronic Analysis Capability.* An electronic analysis capability that permits sorting and presenting data included in the transaction history so as to reconstruct trading and to identify possible trading violations with respect to both customer and market abuse.

(iv) Safe Storage Capability. Safe storage capability provides for a method of storing the data included in the transaction history in a manner that protects the data from unauthorized alteration, as well as from accidental erasure or other loss. Data should be retained in accordance with the recordkeeping standards of Core Principle 14.

Core Principle 10: Financial Standards: Have, monitor, and enforce rules regarding the financial integrity of the transactions that have been executed on the exchange and, where intermediaries are permitted, rules addressing the financial integrity of the intermediary and the protection of customer funds, as appropriate, and a program to enforce those requirements.

(a) *Application Guidance.*

Clearing of transactions executed on a recognized futures exchange should be provided through a Commission-recognized clearing facility. In addition, a recognized futures exchange should maintain the financial integrity of its transactions by maintaining minimum financial standards for its members and having default rules and procedures. The minimum financial standards should be monitored for compliance purposes. The Commission believes that in order to monitor for minimum financial requirements, a recognized futures exchange should routinely receive and promptly review financial and related information. Rules concerning the protection of customer funds should address the segregation of customer and proprietary funds, the custody of customer funds, the investment standards for customer funds, and related recordkeeping.

(b) *Acceptable Practices.* [Reserved]

Core Principle 11: Customer Protection: Have, monitor and enforce rules for customer protection.

(a) *Application Guidance.*

A recognized futures exchange should have rules prohibiting conduct by intermediaries that is fraudulent, noncompetitive, unfair, or an abusive practice in connection with the execution of trades and a program to detect and discipline such behavior. Intermediated markets are not required to have, monitor or enforce rules requiring intermediaries to provide risk disclosure or to comply with other sales practices.

(b) *Acceptable Practices.* [Reserved]

Core Principle 12: Dispute Resolution: Provide for alternative dispute resolution mechanisms appropriate to the nature of the market.

(a) *Application Guidance.*

A recognized futures exchange should provide customer dispute resolution procedures that are fair and equitable and that are made available to the customer on a voluntary basis, either directly or through another self-regulatory organization.

(b) *Acceptable Practices.*

(1) Core Principle 12 requires a recognized futures exchange to provide for dispute resolution mechanisms that are appropriate to the nature of the market.

(2) In order to satisfy acceptable standards, a recognized futures exchange should provide a customer dispute resolution mechanism that is fundamentally fair and is equitable. The procedure should provide:

(i) The customer with an opportunity to have his or her claim decided by a decision-maker that is objective and impartial,

(ii) Each party with the right to be represented by counsel, at the party's own expense,

(iii) Each party with adequate notice of claims presented against him or her, an opportunity to be heard on all claims, defenses and permitted counterclaims, and an opportunity for a prompt hearing,

(iv) For prompt written final settlement awards that are not subject to appeal within the exchange, and

(v) Notice to the parties of the fees and costs which may be assessed.

(3) The procedure employed also must be voluntary and may permit counter claims, as provided in § 166.5 of this chapter.

(4) If the recognized futures exchange also provides a procedure for the resolution of disputes which do not involve customers (*i.e.*, member-to-member disputes), the procedure for the resolution of such disputes must be independent of and shall not interfere with or delay the resolution of customers' claims or grievances.

(5) A recognized futures exchange may delegate to another self-regulatory organization or to a registered futures association its responsibility to provide for customer dispute resolution mechanisms, *Provided, however,* that, if the recognized futures exchange does so delegate that responsibility, the exchange shall in all respects treat any decision issued by such other organization or association as if the decision were its own including providing for the appropriate enforcement of any award issued against a delinquent member.

Core Principle 13: Governance: Have fitness standards for members, owners or operators with greater than 10 percent interest or an affiliate of such an owner, members of the governing board, and those who make disciplinary determinations. The recognized futures exchange must have a means to address conflicts of interest in making decisions and access to, and use of, material non-public information by the foregoing persons and by exchange employees. For mutually owned futures exchanges, the composition of the governing board must reflect market participants.

(a) *Application Guidance.*

(1) A recognized futures exchange should have appropriate eligibility criteria for the categories of persons set forth in the Core Principle which should include standards for fitness and for the collection and verification of information supporting compliance with such standards. Minimum standards of fitness are those bases for refusal to register a person under section 8a(2) of the Act or a history of serious disciplinary offenses, such as those which would be disqualifying under § 1.63 of this chapter. The Commission believes that such standards should include the provision to the Commission of registration information for such persons, whether registration information, certification to the fitness of such persons, an affidavit of such persons' fitness by the facility's counsel or other information substantiating the fitness of such persons. If an exchange provided certification of the fitness of such a person, the Commission believes that such certification should be based on verified information that the person is fit to be in their position. The means to address conflicts of interest in decision-making should include methods to ascertain the presence of conflicts of interest and to make decisions in the event of such a conflict. In addressing the access to, and use of, material non-public information, the Commission believes that the recognized futures exchange should provide for limitations on exchange employee trading.

(2) A recognized futures exchange 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.

(b) *Acceptable Practices.* [Reserved]

Core Principle 14: Recordkeeping: Keep full books and records of all activities related to its business as a recognized futures exchange 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.

(a) *Application Guidance.* [Reserved]

(b) *Acceptable Practices.*

Commission rule 1.31 constitutes the acceptable practice regarding the form and manner for keeping records.

Core Principle 15: Competition: Operate in a manner consistent with the public interest to be protected by the antitrust laws.

(a) *Application Guidance.*

An entity seeking recognition as a recognized futures exchange may request that the Commission consider under the provisions of section 15 of the Act any of the entity's rules, including trading protocols or policies, and including both operational rules and the terms or conditions of products listed for trading, at the time of recognition or thereafter. The Commission intends to apply section 15 of the Act to its consideration of issues under the Competition Core Principle in a manner consistent with that previously applied to contract markets.

(b) *Acceptable Practices.* [Reserved]

PART 170—REGISTERED FUTURES ASSOCIATIONS

11. The authority citation for Part 170 continues to read as follows:

Authority: 7 U.S.C. 6p, 12a, and 21.

12. Section 170.8 is revised to read as follows:

§ 170.8 Settlement of customer disputes (section 17(b)(10) of the Act).

A futures association must be able to demonstrate its capacity to promulgate rules and to conduct proceedings which provide a fair, equitable and expeditious procedure, through arbitration or otherwise, for the voluntary settlement of a customer's claim or grievance brought against any member of the association or any employee of a member of the association. Such rules shall conform to and be consistent with section 17(b)(10) of the Act and be consistent with the guidelines and acceptable practices for dispute resolution found within Appendix A and Appendix B to part 38 of this chapter.

PART 180—ARBITRATION OR OTHER DISPUTE SETTLEMENT PROCEDURES

13. Part 180 is removed.

Issued in Washington, DC, 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]

Dissent of Commissioner Thomas J. Erickson Regarding Final Rules for a New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations

I dissent from the Commission's final rules regarding multilateral transaction execution facilities, or ''MTEFs.'' While I believe this is the most dynamic element of the proposed framework, I also fear that it will only expand the legal uncertainty that the industry has decried for so long in reference to the existing swaps exemption in Part 35. I am thus simultaneously interested in the potential this proposal represents and disappointed in the lost opportunity for clarification.

At its core, my concern is this: The framework will, for the first time, inject legal uncertainty into regulated exchange markets by conferring ''recognition'' upon derivatives transaction facilities, or DTFs, without any determination that the transactions are within the CFTC's jurisdiction. I believe that if an agency of the United States Government tells market participants, other branches of the government, and counterpart foreign regulators that a market is regulated, then it should be, in fact, regulated.

At the DTF level, it seems clear that some markets will not be subject to Commission oversight because the Commission's jurisdiction—over transactions for future delivery and commodity options—will not attach to markets for certain products traded on DTFs. The nature of the Commission's mixed jurisdiction was not lost on commenters to the proposed framework; while some saw this as a flaw in the

proposal,[1] others took comfort in it.[2] Despite this ''don't ask, don't tell'' approach, DTFs all will be ''recognized'' by the Commission as regulated markets.[3] In turn, these DTF markets will hold themselves out to the public as markets regulated by the CFTC.

The Commission and certain commenters within the industry find the possible mix of futures and non-futures products on DTFs acceptable. They rely on Congressional report language from the 1992 legislation that, in effect, allows the Commission to exempt transactions without first determining that they are in the agency's jurisdiction.[4]

In the context of bilateral, privately negotiated transactions—such as those swaps the Commission was directed by Congress to ''promptly exempt—such an exemption makes a certain amount of sense. The consequence of any performance failure or fraud is borne solely by the parties to the transaction.

However, today the Commission extends this rationale to entities that are, in fact, exchange markets. Global participants and international regulators rely on our representations that these markets are regulated. I will not be comfortable making such representations with regard to DTFs where the Commission's jurisdiction is so questionable.

As a secondary matter, I am concerned with the level of oversight that will be applied to all DTF markets. Under the new framework, DTFs generally will not be required to maintain or provide the Commission with reports of futures positions held by their customers that exceed certain thresholds. In what appears to be a nod to the need for these reports, known as ''large trader reports,'' the Commission contemplates collecting this information only in a select, few markets. But the vast majority of markets trading at the DTF level—generally those without retail participants—will have no obligation or duty to the Commission or the public with regard to this important information.

Large trader reports are an essential tool in the Commission's effort to detect and deter market manipulations. Deterrence is important because the effects of market manipulations reach far beyond the market's participants. Consumers ultimately pay for manipulations in commodity markets: Home buyers pay higher interest rates; commuters pay higher prices for gasoline; and we all pay higher prices for heating oil and food. For these reasons, I would require large trader reports in all DTF markets, regardless of the type of commodity product or participant involved.

The Department of the Treasury identified this issue in its comment letter, stating that ''large trader reporting requirements have worked well in the market for treasury futures, both for the information they reveal to regulators and their deterrent effect.''[5] I could not agree more strongly with the Treasury Department on this point. While it appears that large trader reporting will attach to government securities markets, I do not understand why the Treasury's views have not provided just as compelling a rationale for other markets which are not nearly as deep or liquid.

I believe that DTF markets may prove to be very successful, commercially. They may well grow to be the commercial markets where pricing and price-basing of commodities occurs. The Commission would be wise to retain its ability to detect and deter manipulations at their incipience.

Dated: November 20, 2000.

Thomas J. Erickson,

Commissioner.

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[1] *See* Mercatus letter, Aug. 21, 2000, p. 4 (''While it may be appropriate for the CFTC to avoid such a determination in granting an exemption from regulation, it is not clear that the CFTC can exercise its antifraud authority in relation to a particular transaction without determining that the CFTC is authorized to exercise jurisdiction in the first instance.'') The drafters of the Mercatus letter further note that the ''broad definition of MTEF'' in the proposed rules could even be read ''to cover auction markets such as eBay and all other forms of B2B trading facilities, whether electronic or not.'' *Id.* at 5. The Commission attempts to deflect this criticism in the final rules, stating that ''so long as a facility auctions instruments outside of the Commission's regulatory jurisdiction under the Act, [the] exemptions therefrom and this framework would have no application to its business.'' *See* Final Rules for a New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations, pp. 13–14. The Commission's response misses the rudimentary point that it will be anyone's guess whether some instruments possibly traded on DTFs are within or outside the Commission's jurisdiction.

[2] *See* Lehman Brothers letter, Sept. 5, 2000, p. 2 (''[T]he Commission's jurisdiction extends solely to futures and commodity options, such that reserving anti-fraud and anti-manipulation authority over futures and commodity options merely restates the current state of law. Such a reservation of authority cannot, legally, extend to transactions other than futures and commodity options and repeating the nature of the agency's statutory jurisdiction carries no legal baggage.'')

[3] The only apparent penalty for refusing to comply with Commission rules is the market's loss of recognition as a DTF. I am not comfortable with this after-the-fallout remedy, and I cannot imagine potential market participants or domestic or international regulators being any more pleased.

[4] *See* A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations, p. 11, citing H.R. Rep. No. 978, 102d Cong., 2d Sess. 82–83 (1992).

[5] *See* Department of Treasury letter, Aug. 16, 2000, p. 4.

COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 1, 3, 4, 140, 155 and 166

RIN 3038–AB56

Rules Relating to Intermediaries of Commodity Interest Transactions

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rules.

SUMMARY: As part of a comprehensive regulatory reform process, the Commodity Futures Trading Commission (CFTC or Commission) has revised its rules relating to intermediation of commodity futures and commodity options (commodity interest) transactions. These new rules and rule amendments will provide greater flexibility in several areas. For example, to ease barriers to entry for persons seeking registration as futures commission merchants (FCMs) or introducing brokers (IBs), the Commission has established a simplified registration procedure for those persons who are regulated by other federal financial regulatory agencies and who limit their customer base to institutional customers only, regardless of the type of market involved.

With respect to trading on recognized derivatives transaction facilities (DTFs), the Commission has determined to permit non-institutional customers to enter into transactions thereon, provided that such non-institutional customer business is transacted either through a registered FCM that is a clearing member of at least one designated contract market or recognized futures exchange (RFE), and that has adjusted net capital of at least $20 million or by a registered commodity trading advisor (CTA) who has discretionary authority over the non-institutional customer's account, and who has assets under management of not less than $25 million. The latter circumstance is an expansion of the proposal.

As proposed, the Commission is expanding the range of instruments in which FCMs may invest customer funds. In response to various comments concerning the expansion of permissible investments, the Commission is making certain adjustments to the proposals relating to, among other things, concentration limits as applied to securities held in connection with repurchase transactions, permissible investments in FCMs and their affiliates by money market mutual funds meeting the requirements of Rule 2a–7 under the Investment Company Act of 1940 (Investment Company Act), and investment in foreign sovereign debt. Separately, the Commission also is considering proposing risk-based capital rules for FCMs. Further, the Commission recently adopted a revised interpretation concerning the treatment of customer funds on deposit with

FCMs for the purpose of trading on foreign markets under Rule 30.7.[1]

In addition, the Commission is announcing herein the adoption of other new rules and rule amendments, concerning the definition of the term ''principal,'' certified financial reports, ethics training, disclosure, account opening procedures, trading standards, reporting requirements, and offsetting positions, as proposed. The Commission has made additional changes to allow a registrant to notify the Commission when a new natural person is added as a principal ''promptly'' after the change occurs. With respect to pre-dispute arbitration agreements between an institutional customer and a Commission registrant, the Commission has determined to allow such parties to negotiate any or all terms of the agreement, provided that the signing of such agreement by the institutional customer cannot be made a condition of doing business with the registrant. The Commission has also determined to allow any counterclaim to be heard as part of an arbitration proceeding between a non-institutional customer and a registrant where the parties have agreed in advance that all such claims must be included in the proceeding, provided that the aggregate value of the counterclaim is capable of calculation and that the counterclaim arises out of a transaction subject to Commission jurisdiction.

EFFECTIVE DATE: February 12, 2001.

FOR FURTHER INFORMATION CONTACT: Lawrence B. Patent, Associate Chief Counsel, Paul H. Bjarnason, Jr., Special Advisor for Accounting Policy (with respect to Rule 1.25 concerning investment of customer funds), or Ky Tran-Trong, Attorney-Advisor, Division of Trading and Markets, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, D.C. 20581. Telephone: (202) 418–5450.

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I. Introduction

A. Background

In accordance with the recommendations made in a staff task force report submitted to the Commission's Congressional oversight committees on February 22, 2000, the Commission on June 22, 2000 published a proposed new regulatory structure intended to adapt to the changing needs of the modern marketplace (New Regulatory Framework).[2] In reviewing its regulatory structure for intermediaries, the Commission in its proposal (Proposing Release) identified eight Core Principles that it believes are fundamental to assuring proper conduct by intermediaries of commodity interest transactions.[3] Although the Commission did not propose these Core Principles as rules, they guided the Commission in its regulatory reform efforts, as the Commission reviewed all of its rules related to intermediaries in light of the Core Principles. The Commission proposed reforms contemplating greater flexibility for intermediaries and their customers via a regulatory structure that acknowledges the different levels of safeguards appropriate to the types of instruments, customers, and markets involved.

To the extent that an existing rule was not addressed in the Proposing Release, and no amendment thereto has been adopted, the rule will apply to intermediaries transacting business on behalf of customers on contract markets, RFEs and DTFs. When an intermediary transacts business on an exempt multilateral transaction execution facility (exempt MTEF), these transactions are subject only to the Commission's antifraud and antimanipulation authority to the extent applicable.[4] Similarly, where a DTF permits trading only on a principal-to-principal basis, CFTC rules related only to intermediaries will not be applicable to such a market structure.[5]

The Core Principles that guided the Commission in its review of rules applicable to intermediaries, which relate to registration, fitness of registrants, financial requirements, risk disclosure, trading standards, supervision of personnel, large position reporting requirements, and recordkeeping, are as follows:

1. Registration Required

Any person or entity intermediating a transaction on an RFE, or on a DTF that permits intermediation of trading, must be registered in the appropriate capacity with the Commission as an FCM, IB, CTA, commodity pool operator (CPO), associated person (AP) of any of the foregoing, or floor broker (FB). In addition, a person trading solely for his or her own account on an RFE or DTF with a trading floor must register as a floor trader (FT).

2. Fitness of Registrants

Intermediaries and FTs in all markets recognized by the CFTC must be and remain fit.

3. Financial

FCMs must keep and safeguard customer money and FCMs and IBs must have sufficient capital to ensure their capacity to meet their obligations to customers.

4. Risk Disclosure

Intermediaries must provide to customers risk disclosure appropriate to the particular instrument or transaction and the customer.

5. Trading Standards

Intermediaries and their affiliated persons are prohibited from misusing knowledge of their customers' orders.

6. Supervision

All intermediaries, including APs having supervisory responsibilities, must diligently supervise all commodity interest accounts that they carry,

[1] 65 FR 60558 (Oct. 11, 2000). Unless otherwise noted, Commission rules referred to herein are found at 17 CFR Ch. I (2000).

[2] *See* A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations, 65 FR 38986; Rules Relating to Intermediaries of Commodity Interest Transactions, 65 FR 39008; A New Regulatory Framework for Clearing Organizations, 65 FR 39027; Exemption for Bilateral Transactions, 65 FR 39033.

[3] 65 FR 39008.

[4] *See id.* at 39009 nn.1–3.

[5] *See id.* A more complete description of the various new market structures can be found in ''A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations,'' published elsewhere in today's edition of the **Federal Register.**

operate, advise, introduce, handle, or trade, as well as all of the other activities that arise in their business as intermediaries. All intermediaries must establish, maintain, and enforce supervisory procedures.

7. Reporting of Positions

All intermediaries must report to the Commission, RFE or DTF information that permits the Commission, RFE, or DTF to identify concentrations of positions and market composition. Reports of transactions on RFEs are required on a routine and non-routine basis, as is the case for transactions on contract markets. Reports of transactions on an institutional-participant DTF are required only on a non-routine basis.[6]

8. Recordkeeping

All intermediaries (and FTs) must keep full books and records of all activities related to their business as an FCM, IB, CPO, CTA, FB, or FT, in a form and manner acceptable to the Commission for a period of five years. Such information must be readily available during the first two years and be produced to the Commission at the expense of the person required to keep the books or records. All such books and records shall be open to inspection by any representative of the Commission or the U.S. Department of Justice.

Certain of the Commission's rule amendments, such as those concerning ethics training and the definition of the term ''principal,'' will affect all registered firms. The other new rules and rule amendments will affect mainly FCMs and IBs, and are not applicable to CPOs and CTAs. The Commission intends to consider further rulemaking proposals at a subsequent date that will focus more directly upon Part 4 of the Commission's rules, which governs the operations and activities of CPOs and CTAs.[7]

B. The Comments Received

The Commission received 81 comment letters on the New Regulatory Framework, 51 of which were posted to the comment file on intermediaries on the Commission's web site. Of those 51 comment letters, 31 letters addressed specific provisions of the Proposing Release: five from U.S. commodity exchanges; two from the National Futures Association (NFA); one from the Futures Industry Association (FIA); six from other futures industry professional associations; one from the Federal Reserve Bank of Chicago (FRBC); one from the Department of the Treasury (Treasury); one from a provider of ethics training programs for the futures industry; five from firms registered as FCMs; one from a margin settlement bank for various U.S. exchanges and clearing corporations; three from trade associations representing the grain industry; one from a group of trade associations representing various producer groups; two from public policy centers; one from a single firm registered as an FCM, CPO and CTA; and one from a certified public accounting firm. These commenters, as well as those that addressed the concept of regulatory reform in a more general fashion, expressed strong support for the Proposing Release, but some suggested that the relief did not go far enough towards replacing the Commission's regulatory framework concerning intermediaries with core principles.[8]

The Commission has carefully reviewed all of the comments received. Based upon this review, the Commission generally has determined to adopt the new rules and amendments as proposed in the Proposing Release. In response to the comments, the Commission has also decided, however, to modify the proposal in several respects. First, the Commission has determined to expand the ''passport'' provisions with respect to those FCMs and IBs that are already registered with the Securities and Exchange Commission (SEC) in a similar registration capacity, or that are authorized to perform these functions by a federal banking authority. As adopted, these rules will allow those FCMs and IBs to follow a simplified registration procedure in order to conduct business solely for institutional customers on designated contract markets and RFEs, in addition to DTFs. Second, the Commission has determined to permit certain CTAs to place trades on a DTF on behalf of non-institutional customers, provided that the non-institutional customer's investment decisions are directed by the CTA and that total assets over which the CTA has discretionary authority are not less than $25 million. The proposal would have required non-institutional customers wishing to trade on DTFs to transact their business only through an FCM with at least $20 million in adjusted net capital that is also a clearing member of at least one designated contract market or RFE.[9] Third, the Commission has made adjustments to its rules governing permissible investments for customer funds in response to the comments received. Fourth, the Commission has adopted additional changes to allow a registrant to notify the Commission ''promptly'' after a new principal is added, rather than prior to the change as was the case previously. Fifth, with respect to pre-dispute arbitration agreements between an institutional customer and a Commission registrant, the Commission has determined to allow such parties to negotiate any or all terms of such agreements, provided that the signing of the agreement may not be made a condition of doing business with the registrant. Sixth, the Commission has decided to permit any counterclaim arising out of a transaction subject to the Commodity Exchange Act (Act) or regulations thereunder to be heard as part of an arbitration proceeding between a non-institutional customer and a registrant where the parties have agreed in advance that all such claims must be included in the proceeding.

In the Proposing Release, the Commission gave a detailed explanation for each revision that it proposed to

[6] As discussed in a companion release in today's edition of the **Federal Register**, large trader reports will not be required from participants trading on a DTF restricted to commercial participants, except where the Commission specifically orders otherwise.

[7] The Commission wishes to make clear that its regulatory reform efforts are an ongoing process. Thus, for example, as a part of the regulatory reform process, the Division of Trading and Markets recently permitted designated self-regulatory organizations (DSROs) to conduct ''risk-based'' auditing and thereby take into account a firm's business practices in establishing the scope and timing of audits. *See* Financial and Segregation Interpretation No. 4–2, CFTC Staff Letter 99–32, [1998–1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,745 (Aug. 20, 1999). Similarly, the Commission is considering amendments to the minimum capital requirements for FCMs. Those proposed amendments would contain an approach, generally referred to as ''risk-based'' capital requirements, that is based more upon position risk than is the case under the current rules.

[8] Commenters are generally identified by name below when their comments are discussed. Citations to comment letters are denoted as ''CL 22–x.'' The number 22 represents the comment file for the Proposing Release and ''x'' is the number assigned to a particular comment letter as set forth on the Commission's website, www.cftc.gov.

[9] As explained in the separate release on ''A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations'' in today's edition of the **Federal Register**, however, the Commission is amending its proposal to permit a non-institutional customer to enter an order directly to a DTF's electronic trading platform where the customer's account is carried by a registered FCM with at least $20 million in adjusted net capital that is also a clearing member of at least one designated contract market or RFE, provided that such FCM's credit filter is maintained as part of the DTF's electronic trading platform. *See* § 37.2(a)(2)(ii)(A).

In addition, FTs and FBs will be permitted to trade for their own account on a DTF, even if they would not otherwise come within the definition of an institutional customer, provided that their obligations in connection with their trading on the DTF are guaranteed by an FCM. *See* § 37.1(b)(1), (2). Generally, an FT or an FB must have total assets exceeding $10,000,000 to be considered an institutional customer. *See* §§ 1.3(g), 35.2(b)(10), (11).

make to the rules relating to intermediation of commodity interest transactions. The scope of this **Federal Register** release generally is restricted to the comments received on the Proposing Release and changes to the proposed new rules and rule amendments that the Commission has made in response thereto. Accordingly, the Commission encourages interested persons to read the Proposing Release for a discussion of the background and purpose of each of the rule amendments that is not described in detail in this **Federal Register** release.

The Proposing Release also presented several sets of questions intended to elicit public comments on various issues. For instance, the Commission requested comment concerning the need to update and to make more flexible its minimum net capital requirements for FCMs by permitting the application of risk-based net capital requirements.[10] In response to the comments received, the Commission plans to separately propose various rules and amendments addressing risk-based capital requirements. The Commission also posed certain questions related to the treatment of customer funds.[11] Reactions were mixed regarding these additional issues. Consequently, the Commission will continue to study these issues.

II. Responses to the Comments Received

A. General

As noted above, several commenters urged the Commission to revoke many of the rules that govern the relationship between futures and options customers and intermediaries, and to adopt in their place a set of core principles and statements of acceptable practices that reflect the ''largely institutional nature of derivatives market participants.'' (CL 22–31 at 2–3; see also CL 22–22 at 9; CL 22–24 at 1; CL 22–39 at 8; CL 22–35 at 11) In particular, FIA commented that:

> [We have] identified the following core principles that we believe should govern intermediaries in the conduct of their business, without regard to the market on which a transaction is executed: (1) Registration of intermediaries and their associated persons; (2) minimum financial requirements; (3) protection of customer funds appropriate to the type of customer; (4) prohibition against fraud and manipulation; (5) large trader reporting requirements; and (6) recordkeeping. These core principles, combined with an effective self-regulatory organization audit program to assure that intermediaries have developed and are enforcing adequate internal controls[,] should achieve the Commission's regulatory purpose. (CL 22–31 at 3 (footnotes omitted))

In general, the Commission believes that it is more expeditious at this time to adopt the specific regulatory reforms contemplated in the original release. Replacing the current rules with core principles might have delayed these changes, and in some instances, resulted in no practical benefit to the regulated community. To use Rule 1.55 as an example, the development of a core principle approach in this area would have required the Commission to propose the repeal of Rule 1.55 and the adoption of a core principle for disclosure together with a Statement of Acceptable Practices. The Statement of Acceptable Practices would likely provide, as the rule does now, no standard disclosure requirement for institutional customers and the basic single-page statement now applicable to non-institutional customers. At the end of this process, there would be no discernible change in FCM or IB operations. Firms might theoretically be freer to develop their own statements, but to clear them through counsel and self-regulatory organization (SRO) staff would likely be costly and time-consuming. Accordingly, the Commission did not believe that it would be an effective use of the Commission's or the industry's resources at this time to replace Rule 1.55 solely for the purpose of establishing a core principle concerning disclosure. The Commission reaches similar conclusions with respect to the repeal of other rules.

Second, the Commission believes that certain issues, such as the computation of capital for a financial intermediary, do not lend themselves easily to a core principle approach. As one commenter observed: ''Capital and segregation requirements * * *'' must be spelled out in detail to ensure the integrity of customer funds.'' (CL 22–24 at 1)

Third, as the New York Mercantile Exchange (NYMEX) noted, a re-examination of the Commission's rules applicable to intermediaries with a goal towards replacing them with a set of Core Principles and statements of acceptable practices ''would require an intensive review of the applicable rules in this area,'' and accordingly, ''undertaking such an examination as part of the current Reform Proposal could so greatly lengthen the process as to undermine the entire reform effort.'' (CL 22–32 at 16–17)

Nevertheless, the Commission's decision at this time not to use a core principles approach with respect to intermediaries will not affect its commitment to the continued review of the rules affecting intermediaries to determine where core principles are appropriate.[12] In this regard, the Commission notes the request it made in the Proposing Release for specific comments concerning existing rules and suggested modifications thereto.[13] The Commission further notes that under Rule 140.99, there remains a procedure in place whereby the Commission's staff may consider specific individual circumstances and, where warranted, the Commission's staff may grant interpretative, exemptive, or no-action relief from requirements under the Act or Commission rules to individuals or entities requesting such relief.

Certain commenters specifically addressed the need for further regulatory relief with respect to CPOs and CTAs. (CL 22–22 at 9; CL 22–43 at 5–6; CL 22–47 at 2) The Commission recognizes that CPOs and CTAs represent ''important sectors of the futures industry.'' (CL 22–22 at 2) As stated above, the regulatory reform process is an ongoing one. The Commission continues to explore additional areas in which relief for CPOs and CTAs may be warranted, *e.g.,* Part 4 of the Commission's rules, and will be making further rulemaking proposals.

With specific regard to recordkeeping, the Commission in 1999 adopted amendments to the recordkeeping requirements of Rule 1.31 in order to allow recordkeepers to store most records on either micrographic or electronic storage media for the full five-year period, thereby harmonizing procedures for those firms regulated by both the Commission and the SEC.[14] In order to avoid undue hardship, the Commission later extended the effective date of the requirement that recordkeepers using only electronic storage media enter into arrangements with third-party technical consultants.[15] The Commission's staff is continuing to work with industry representatives to implement this procedure.

[10] 65 FR at 39012.

[11] *Id.* at 39014–15.

[12] Should the Commission in the future adopt core principles in the place of some of its existing regulations as they pertain to intermediaries, NFA urged the Commission to look to NFA and the industry to develop the acceptable practices for satisfying many of these core principles, subject to Commission approval. (CL 22–24 at 2) The Commission notes that it has already taken such an approach in certain areas, *e.g.,* disclosure to non-institutional customers trading on DTFs, and looks forward to continuing to work with NFA and the industry in developing acceptable practices in additional areas.

[13] 65 FR at 39009.

[14] 64 FR 28735 (May 27, 1999).

[15] 64 FR 36568 (July 7, 1999).

B. Core Principle One: Registration

1. Definition of the Term ''Principal''

Under Commission staff's prior interpretation of the definition of the term ''principal'' in Rules 3.1(a)(1) and 4.10(e)(1),[16] all officers of a registrant were treated as principals and required to register as such. In response to changes in management structures over the last 20 years and requests from registrants that certain employees, such as some vice presidents, not be considered principals because they do not exercise a controlling influence over the registrant or any of its activities subject to Commission regulation, the Commission proposed to amend Rules 3.1(a)(1) and 4.10(e)(1) by defining as principals persons within a given organizational structure who hold specific offices.[17] A registrant would, therefore, no longer be required to treat every officer as a principal, but only those who met the criteria of the rule as revised.

Commenters were strongly in support of the proposal to amend the definition of ''principal'' to reduce the number of persons required to be registered, and the Commission is adopting the amendments as proposed.[18] (CL 22–22 at 11; CL 22–24 at 3; CL 22–25 at 2; CL 22–31 at 13; CL 22–32 at 16) The Managed Funds Association (MFA) asked the Commission to confirm that the reference in the proposed amendment to the ''principal'' definition to ''any person in charge of a business unit subject to regulation by the Commission'' applied solely to ''the aggregate business unit acting in a registered capacity and not subsidiary divisions or units such as marketing, human resources, audit, and other departments within an operating entity.'' (CL 22–22 at 11) The Commission agrees with this interpretation, and reiterates that the intent of the amended ''principal'' definition is to reduce the number of officers that will be considered principals, while ensuring that appropriate personnel, *e.g.,* those that exercise, or are in a position to exercise, ''a controlling influence over the registrant or any of its activities subject to Commission regulation,'' [19] remain listed as such.

The Commission also has determined to adopt, as proposed, conforming changes to Rules 4.24(f)(1)(v), 4.25(a)(8)(ii)(A) and 4.25(c)(2)(i)(B), applicable to CPOs, and 4.34(f)(1)(ii) and 4.35(a)(7)(ii)(A), applicable to CTAs, as incorporated by reference in amended Rule 4.10(e)(1). Accordingly, CPOs and CTAs will only be required to provide business backgrounds and proprietary trading results for those principals who participate in making trading or operational decisions, or supervise persons so engaged, and not all officers.[20]

In response to suggestions by FIA, the Commission has determined to delete Rule 3.32, which specifies certain events or changes within a firm's management structure that require the firm to file a new registration form. (CL 22–31 at 13–14) The Commission is adding a new paragraph (a)(2) to Rule 3.31 to require the registrant to file a Form 8–R on behalf of each new natural person principal who was not listed on the registrant's Form 7–R ''promptly'' after the change occurs. Rule 3.31(a)(2) was drafted to closely parallel Rule 3.10(a)(2)(i), and provides that, if the change that renders the application for registration deficient or inaccurate results from the addition of a new principal without a current Form 8–R on file with NFA, a Form 8–R for that principal must accompany the Form 3–R amending the registrant's application for registration.[21]

2. Special Procedures Available to Firms Subject to Securities or Banking Regulation

The Commission proposed to amend Rule 3.10 to simplify the registration process for FCMs or IBs who conduct business solely for institutional customers on a DTF, and who are already registered with the SEC in a similar registration category or who are authorized to perform these functions by a federal banking authority.[22] The Commission stated in the Proposing Release that such applicants would be registered as an FCM or IB upon filing notice with NFA of their intent to undertake such limited activities, together with a certification that they are registered or authorized to engage in a similar function by, and are in good standing with, the SEC or a federal banking authority. In addition, individuals acting in the capacity of APs for such FCMs or IBs need not be registered or listed, and would not be subject to proficiency testing or ethics training requirements. These firms and their salespersons would remain subject to antifraud provisions, however.[23]

The Chicago Mercantile Exchange (CME), along with other commenters, stated that the ''passporting'' provisions did not go far enough and urged the Commission to extend the provisions to allow those persons who are regulated by the SEC or a federal banking agency, and who opt to register as an FCM or IB under the simplified registration procedure, to conduct business for institutional customers on all trading platforms, rather than limit their access to DTFs.[24] (CL 22–35 at 12; *see also* CL 22–24 at 3–4; CL 22–25 at 2–3) In support of this recommendation, the Chicago Board of Trade (CBT) stated, ''[i]f the nature of the entity or individual intermediating the transaction and the nature of the customer determines the need for any particular requirement, whether the transaction facility is a DTF or an RFE is irrelevant.'' (CL 22–25 at 3; *see also* CL 22–35 at 15)

In contrast, however, the National Introducing Brokers Association (NIBA) urged that any person or organization conducting any commodity interest business should be subject to full registration requirements (CL 22–17 at 4), while MFA stated that firms making use of the ''passport'' procedure should be subject to a limitation upon their commodity interest business, such as a requirement that their commodity interest activities be incidental to their primary business as a broker-dealer or bank. (CL 22–22 at 11–12)

Upon consideration of the comments received, the Commission agrees that given the nature of the customers (*i.e.,* solely institutional customers) for whom a securities broker-dealer or bank would

[16] Rule 3.1(a) defines ''principal'' for purposes of the Commission's Part 3 rules, which govern registration. Rule 4.10(e) defines ''principal'' for purposes of the Commission's Part 4 rules, which apply to the activities of CPOs and CTAs.

[17] 65 FR at 39010.

[18] As amended, the ''principal'' definition will continue to include all directors of a corporate registrant. In addition, the definition will include the general provision that defines as a principal any person occupying a similar status as or performing similar functions to those persons specifically listed, having the power, directly or indirectly, through agreement or otherwise, to exercise a controlling influence over a firm's activities that are subject to regulation by the Commission. As noted in the Proposing Release, what constitutes ''a controlling influence'' will be left for determination on ''a case-by-case basis.'' *Id.* at 39011 n.11.

[19] *Id.* at 39010.

[20] *Id.* at 39011.

[21] An additional conforming change was made to § 3.21(c) to reflect the deletion of § 3.32, and the addition of new paragraph (a)(2) to § 3.31.

[22] 65 FR at 39011–12.

[23] *Id.* at 39012.

[24] In this regard, the CME stated that given the restrictions of the DTF market structure:

The proposed rulemaking provides no relief whatsoever to a securities broker-dealer (not also registered as a FCM) that wishes to execute transactions in both stock index futures and the underlying stocks in order to implement an asset allocation strategy for its institutional customers. So long as the customers are sophisticated institutions, we can see no regulatory reason not to allow them to use the federally-regulated intermediary of their choice in effecting transactions in a futures market, regardless of whether the market is regulated as a designated contract market, an RFE, a DTF or an exempt MTEF. (CL 22–35 at 12)

be acting as an FCM or IB, the securities broker-dealer or bank should be eligible for the simplified FCM or IB registration procedures, irrespective of the type of exchange on which the customer seeks to conduct its transactions. Accordingly, the Commission has adopted Rule 3.10(a)(1)(i)(B) to permit an individual or entity who is registered with the SEC as a broker-dealer, or has been authorized by the appropriate banking authority, to register as an FCM or IB simply by filing notice with NFA, together with a certification of registration with the appropriate financial regulator.[25] Such FCMs and IBs who are otherwise regulated by another federal financial regulator will be permitted to conduct business solely for institutional customers on any designated contract market, RFE or DTF.[26] The Commission notes, however, in accordance with FIA's comments, that the simplified registration procedure is limited to banks themselves, and not to their affiliates, and further, that once registered, securities broker-dealers and banks would be subject to the same rules that govern all FCMs and IBs. (CL 22–34 at 13)

Although ''passported'' firms will be eligible for the simplified FCM or IB registration procedures without regard to the type of exchange on which their institutional customers seek to conduct business, the Commission has determined to adopt Rules 1.17(a)(2)(iii) and 1.52(m), as proposed, without making further changes. Under Rule 1.17(a)(2)(iii), the Commission would not require an FCM or IB registered under the ''passporting'' procedures in Rule 3.10(a)(1)(i)(B) to meet the Commission's minimum financial requirements if (i) it meets the appropriate net capital requirements of its primary regulator, (ii) its activities are limited to serving institutional customers trading on DTFs that do not require compliance with CFTC minimum financial requirements for such ''passported'' firms, and (iii) it conforms to minimum financial standards and related reporting requirements set by such DTF in its bylaws, rules, regulations or resolutions.[27]

If, however, the ''passported'' FCM or IB chooses to conduct transactions on behalf of its institutional customers on a contract market or RFE in addition to its DTF activities, the firm would then be required to satisfy the Commission's minimum financial requirements. The Commission believes that this requirement is important to protect the financial integrity of these markets because a customer default may have ancillary impacts not just on other customers of the affected firm, but also on other firms and their customers transacting business on such markets. Moreover, because the Commission anticipates that ''passported'' firms will conduct most of their business in the securities or banking fields, with only a minor portion of their activities involving commodity interests, the requirement that such firms meet the Commission's minimum financial requirements if they conduct business for their institutional customers on a contract market or RFE should not impose a significant burden. Rules 1.17(a)(1)(i) and (ii) already require the dually registered FCM or IB to meet the greater of either the Commission's or SEC's minimum financial requirements, and in most cases, those entities that conduct most of their business in the securities or banking fields will have satisfied the Commission's minimum financial requirements by meeting the SEC capital requirements. Similarly, the Commission allows a dually registered FCM or IB to satisfy the basic financial reporting requirements of Rule 1.10 by filing a copy of its FOCUS report in lieu of a Form 1–FR. In addition, Rule 1.52(m) is adopted as proposed to relieve a DTF from the requirement that it adopt for ''passported'' firms, the Commission's minimum adjusted net capital standards.[28]

The Commission continues to encourage the SEC to consider reciprocal amendments to its rules to accommodate FCMs and IBs that are not now dually registered as securities brokers or dealers, but that may wish to act as intermediaries in the securities markets.

The Commission also noted in the Proposing Release that it was considering updating and making more flexible its minimum net capital requirements with respect to FCMs, specifically with respect to adopting risk-based net capital requirements.[29] Commenters were overwhelmingly in favor of this proposal, and the CBT further noted that it had, along with the Board of Trade Clearing Corporation (BOTCC) and the CME, already adopted risk-based capital requirements at the clearing organization level. (CL 22–25 at 3) The Commission is separately considering proposing rules related to risk-based net capital requirements.[30]

3. Standard Application Procedures for FCMs and IBs

The Commission proposed that applicants for registration as FCMs or IBs who raise their own capital to satisfy minimum financial requirements would be permitted to file an unaudited financial report indicating satisfaction of the minimum requirements, rather than be required to provide certified financial statements with their registration application.[31] A firm taking

[25] As noted in the Proposing Release, a firm acting in the capacity of an FCM would be required to become a member of a registered futures association. *See* § 170.15. NFA is currently the only registered futures association. NFA Bylaw 1101 essentially provides that no NFA member may deal with another person with respect to an account, order or transaction where the other person is acting in a capacity that requires registration, unless that other person is also a member of a registered futures association. The combination of Commission Rule 170.15 and NFA Bylaw 1101 therefore requires most registrants to become members of NFA.

The Commission may consider not requiring NFA membership in the future if reciprocal arrangements were made by the primary regulators of other financial industry segments to recognize CFTC registration without requiring corresponding SRO membership.

[26] Because an intermediary that conducts business on an exempt MTEF will not be subject to Commission regulation for activity on the exempt MTEF, except for the antifraud and antimanipulation provisions of the Act to the extent applicable, it is unnecessary to extend the ''passporting'' procedure to firms trading on these markets.

[27] 65 FR at 39012.

[28] *Id.*

[29] *Id.*

[30] Although the Proposing Release did not generally address registration procedures for firms that are dually registered with the National Association of Securities Dealers (NASD) and NFA, the Association of Registration Management (ARM) made several suggestions in that area. Among its comments, ARM recommended that: (1) Firms that are dually registered with NASD and NFA should be permitted to maintain internal records about branch office location and supervision of those locations; (2) NFA should be permitted to rely on the fingerprint information available through the NASD's Internet-based Central Registration Depository (Web CRD) database for dual registrants; and (3) NFA also should be permitted to rely on disciplinary and disclosure information filed through amendments to Web CRD. (CL 22–23 at 2–3) ARM also recommended that the Commission eliminate its Form 7–R annual update requirement by allowing NFA to rely upon, and to record changes in a registrant's application through use of, the amendments filed via Form 3–R throughout the year. (CL 22–23 at 1–2)

The Commission's Registration Working Group (RWG) will consider ARM's suggestions in the near future. In this regard, Commission staff indicated in a letter dated July 13, 2000 to NFA that: (1) NFA could rely upon reporting by the futures industry SROs and the Commission with respect to SRO disciplinary actions and Commission enforcement actions; (2) certain requirements related to the collection of employment, residential and educational data could be reduced; and (3) as part of the annual update process, firms would only be required to report any new criminal or civil matters that had arisen since the previous update.

[31] *Id.* However, as stated in the Proposing Release, those IB applicants who do not raise their own capital continue to be required to file a guarantee agreement entered into with an FCM with their registration application. IBs and FCMs should refer to Commission Rules 1.10(j) and 1.57(a)(1) concerning the procedures applicable to guarantee

advantage of the new procedure would be subject to an on-site review within six months of registration by the firm's DSRO or, at the DSRO's discretion, a conference between appropriate staff of the firm and the DSRO at the DSRO's offices. An applicant that did not wish to be subject to the six-month review could continue to follow the existing rules and file a certified financial statement with its application.[32]

In general, commenters supported the proposed elimination of the certified financial statement requirement for IB applicants. (CL 22–17 at 3; CL 22–24 at 4; CL 22–25 at 4) Both NFA and the CBT, however, expressed reservations about eliminating the requirement for FCM applicants. (CL 22–24 at 4; CL 22–25 at 4) In addition, NFA recommended that the Commission consider allowing the DSRO to conduct the six-month review of independent IBs telephonically where the DSRO has no reason to be concerned about the IB's capital. (CL 22–24 at 4) The CBT expressed the view that the six-month time period for the on-site review of the FCM by the DSRO should be calculated from the date the FCM begins customer business, rather than six months from the date of registration. (CL 22–25 at 4).

The Commission has determined to eliminate the requirement to file certified financial statements with FCM or IB registration applications by adopting Rules 1.10 (a)(2)(i)(C) and (a)(2)(ii)(C), generally as proposed.[33] This alternative procedure is modeled on similar procedures in the securities industry. Although the Commission is not requiring FCMs to file a certified financial statement with their application for registration, this does not preclude any SRO from imposing this requirement before accepting an FCM for membership. With respect to the six-month review that must be conducted should an FCM or IB choose not to file a certified financial statement with its registration application, the Commission does not object, in the case of an IB, to allowing the DSRO to conduct the review telephonically where the DSRO does not have reason to question the IB's capital. However, the Commission believes that the six-month time period for the review of both FCMs and IBs should begin from the date the applicant is registered. The Commission has held consistently that once a registrant becomes registered in a certain capacity, the registrant is immediately assumed to be engaging in the activities permitted by such registration.[34]

C. Core Principles Two and Six: Fitness and Supervision

The Commission proposed to delete Rule 3.34 and instead to implement Congressional intent regarding ethics training through a Statement of Acceptable Practices.[35] Rule 3.34 specified frequency and duration of ethics training, the suggested curriculum, qualifications of instructors, and the necessary proof of attendance at such classes. In proposing to replace the rule with a Statement of Acceptable Practices that would leave the format, frequency, and providers of ethics training up to the registrants themselves, the Commission expressed its belief that greater flexibility regarding ethics training and proficiency testing could be afforded to registrants than was permitted under Rule 3.34. For registrants seeking guidance as to the maintenance of proper ethics training procedures consistent with the purposes of the Core Principle that intermediaries must be and remain fit, the Commission stated that the Statement of Acceptable Practices could function as a ''safe harbor.''[36]

In general, commenters expressed strong support for the Commission's proposal, stating, for example, that Rule 3.34 had become ''far too detailed and administratively cumbersome,'' (CL 22–24 at 5) and that ''each registrant should be responsible for implementing an ethics training program that addresses the registrant's business activities.'' (CL 22–31 at 14) Other commenters, however, expressed their beliefs that Rule 3.34 already provided sufficient flexibility to registrants, and that by eliminating the rule, the Commission risks sending the wrong message to the industry regarding the importance the Commission assigns to the ethics requirement. (CL 22–7 at 3; CL 22–43 at 6).

Upon consideration of the comments received, the Commission is deleting Rule 3.34 and issuing the Statement of Acceptable Practices as a new Appendix B to Part 3 of its Rules as proposed. Although the Commission notes the concern that eliminating Rule 3.34 may lead firms to place an inadequate priority on ethics training, the Commission does not believe that the replacement of the rule with a Statement of Acceptable Practices will diminish a registrant's obligations to remain fit and to adequately supervise the handling of customer accounts. Instead, the Commission hopes that the Statement of Acceptable Practices, which allows registrants to adopt ethics training programs that are better tailored to their needs, will help to imbue firms with a ''culture of ethics'' that is ongoing rather than episodic. The Commission believes that the essence of the ethics training or continuing education requirement is to remain current as to the legal requirements applicable to a person's role in the futures industry, which a registrant ignores at his or her peril.

The Commission also proposed to publish its recent ''guidance letters'' issued to NFA concerning the treatment of SRO disciplinary actions in assessing the fitness of FBs and FTs. The guidance letters were issued to provide greater clarity in interpreting the ''other good cause'' ground for statutory disqualification from registration under Section 8a(3)(M) of the Act. Support was expressed for this proposal and, accordingly, the Commission is hereby publishing both letters as an addition to Appendix A to Part 3 of its Rules.[37] (CL 22–25 at 4–5)

The Commission also requested comment regarding additional changes that should be considered in this area. In response, NFA urged the Commission to consider prohibiting exchange ''subscribers'' from accessing electronic exchanges where they have been barred by another exchange. (CL 22–22 at 5) As explained by NFA, the term ''subscriber'' describes the type of person that is equivalent to an FT. The Commission previously stated, when it adopted rules to govern FT registration, that it would defer consideration of the application of such requirements to persons using electronic trading systems to a later date.[38] To date, the Commission has not revisited the issue, and accordingly does not believe that it is appropriate to adopt NFA's request at this time. Nevertheless, the exchanges remain free to ban such ''subscribers''

agreements. *See also First American Discount Corp.* v. *CFTC,* 222 F.3d 1008 (D.C. Cir. Aug. 18, 2000).

[32] 65 FR at 39013.

[33] Rules 1.10(a)(2)(i)(C) and (a)(2)(ii)(C) have been further revised to make clear that the Form 1–FR–FCM or Form 1–FR–IB that must be submitted by new applicants for registration as FCMs and IBs with their application must be dated not more than 17 business days prior to the date on which such report is filed. This is consistent with Rules 1.10(a)(2)(i)(B) and (a)(2)(ii)(B).

[34] *See, e.g., In re Premex,* [1982–1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,992 (Feb. 1, 1984), *aff'd in relevant part, rev'd in part,* 785 F.2d 1403 (9th Cir. 1986).

[35] 65 FR at 39013.

[36] *Id.*

[37] In the Proposing Release, the Commission indicated that these letters would be published as an accompanying statement to this **Federal Register** release. The Commission has determined to add these letters to Appendix A to Part 3 because they relate to the issue of ''other good cause,'' which is discussed at the end of Appendix A, and to provide an easier way to access the texts of these letters.

[38] 58 FR 19575, 19576 (Apr. 15, 1993).

from access pursuant to their own rules and policies. As with the case of certified financial statements for FCM applicants discussed above, SROs may determine to impose requirements that are stricter than the minimum standards set forth in Commission rules.

D. Core Principal Three: Financial Requirements

1. Trading by Non-Institutional Customers on DTFs

Under the New Regulatory Framework, trading on DTFs would be limited to futures and options on specified commodities or those commodities deemed eligible under a case-by-case Commission determination.[39] In addition, DTFs could permit trading in any commodities if trading is limited to qualifying commercial participants.[40] The Commission proposed, however, that under certain conditions a DTF might permit non-institutional customers to enter into transactions thereon.[41] To address the higher degree of risk associated with the lower regulatory protections offered to DTF participants, such non-institutional customer business could be transacted only through a registered FCM that (1) Is a clearing member of at least one designated contract market or RFE, and (2) has a minimum adjusted net capital of at least $20 million.[42] Such an FCM is considered to be more capable of properly handling these transactions and the associated risk. The Commission further noted that, in order to provide guidance to such customers and their FCMs, NFA would issue a Statement of Acceptable Practices regarding additional disclosures to be made to non-institutional customers trading on DTFs and related issues involving price dissemination.[43]

Several commenters objected to the $20 million adjusted net capital requirement for FCMs set forth in Rule 1.17(a)(1)(ii) as proposed, stating that the amount was arbitrary, and urging that it be eliminated or reduced. (CL 22–35 at 8; CL 22–46 at 3–4; CL 22–48 at 3) The CBT observed that the $20 million minimum adjusted net capital requirement would prevent more than half of all registered FCMs from intermediating on DTFs for retail customers. (CL 22–25 at 5) Instead, the CBT suggested that the Commission focus on the FCM's record of customer protection, and permit any registered FCM to transact retail customer business on a DTF if the firm: (1) Has been registered as an FCM for at least three years; and (2) has not been found by a governmental or SRO authority to have committed any sales practice violations against retail customers during the past three years. (CL 22–25 at 5) Goldenberg, Hehmeyer & Co. (GHC) recommended that the Commission apply risk-based capital requirements in lieu of the $20 million minimum net capital requirement to assess the FCM's financial soundness. (CL 22–19 at 1–2) In a somewhat related vein, Treasury commented that a more appropriate measure of an intermediary's soundness is the amount of adjusted net capital in excess of the minimum required by regulation. (CL 22–34 at 3–4) Treasury further observed, however, that because the Commission's adjusted net capital requirements are based on the amount of segregated funds, whether excess adjusted net capital is an appropriate measure of an FCM's soundness in addition to total adjusted net capital depended on what the Commission ultimately decided on the segregation of funds issue. Accordingly, Treasury recommended that the Commission consider the segregation of funds issue in conjunction with its review of net capital rules. (CL 22–34 at 3–4)

Although MFA supported the Commission's proposal to allow non-institutional customers access to DTFs through qualifying FCMs (*i.e.,* those that are clearing members of at least one designated contract market or RFE and that have at least $20 million in adjusted net capital), it urged that customers who opted to trade through certain registered CTAs should also have such access. (CL 22–22 at 5) Specifically, MFA recommended that CTAs with at least $25 million in assets under management be permitted to access both exempt MTEFs and DTFs and engage in transactions on behalf of their customers in those markets. In support, MFA pointed out that in adopting Rule 30.12, which included in the definition of ''authorized customer'' any person whose investment decisions with respect to foreign futures and foreign option transactions are made by a CTA with total assets under management exceeding $50 million,[44] the Commission recognized that where a professional asset manager such as a CTA acts for a customer, it is appropriate to rely on the financial sophistication of the person managing the assets rather than on the sophistication of the individual CTA client. (CL 22–22 at 5) MFA further stated that because customers select their CTAs precisely on the basis of their determination that those CTAs are best qualified to make trading decisions on their behalf, precluding a CTA from being able to access DTF markets ''would * * * deprive customers of their ability to elect and receive the full benefits of the professional management for which the customer has retained the CTA.'' (CL 22–22 at 6) MFA estimated that less than 10 percent of all registered CTAs would qualify under a $25 million assets under management threshold, and expressed the view that this ''small but sophisticated'' class of CTAs would be an appropriate group for the Commission to permit access to all types of futures markets. (CL 22–22 at 8)

The Commission has reviewed these comments carefully. The Commission has determined to adopt, as proposed, the $20 million minimum adjusted net capital requirement for FCMs wishing to transact business on behalf of non-institutional customers on a DTF. The Core Principle addressing financial standards encourages intermediaries to maintain adequate capital to ensure they are able to meet their obligations to customers, and the Commission believes that the $20 million adjusted net capital requirement is a sufficient proxy for ensuring that FCMs will be financially capable of properly maintaining and servicing customer accounts. The Commission will monitor the effects of this requirement and make adjustments if appropriate.

The Commission has determined to add a new Rule 4.32 to permit registered CTAs to enter trades on or subject to the rules of a DTF on behalf of a non-institutional client, provided that the CTA: (1) Directs the client's commodity interest account;[45] (2) directs accounts containing total assets of not less than $25 million at the time the trade is entered; and (3) discloses to the client that it may enter trades on a DTF on the client's behalf. Paragraph (b) of Rule 4.32 further requires that the client's commodity interest account be carried by a registered FCM. An FCM who receives orders on behalf of a non-institutional customer from a CTA acting in accordance with Rule 4.32 need not maintain $20 million in minimum adjusted net capital, however. *See* Rule 1.17(a)(1)(ii)(B). In addition, a CTA placing trades on a DTF on behalf of a non-institutional client will be required to make any necessary

[39] 65 FR at 38990.

[40] *Id.*

[41] 65 FR at 39013.

[42] *Id.*

[43] *Id.*

[44] 65 FR at 47277.

[45] The term ''direct,'' as defined in Rule 4.10(f), refers to, in the context of trading commodity interest accounts, ''agreements whereby a person is authorized to cause transactions to be effected for a client's commodity interest account without the client's specific authorization.''

disclosures pursuant to Rule 4.34(h), which requires a CTA to disclose to the client if, pursuant to Rule 1.46, the CTA has instructed the FCM carrying the client account either not to close out all offsetting positions or to close out offsetting positions on other than a first-in, first-out basis. This issue is discussed in greater detail below.

2. Segregation of Funds

The Proposing Release raised two sets of questions seeking comments about whether, and under what circumstances, the Commission should permit (1) customers to opt out of segregation and (2) FCMs to maintain, in the same customer segregated account, various instruments, such as over-the-counter (OTC) derivatives, equity securities, and other cash market positions, as well as the funds used for the purpose of securing or margining such products and positions.[46] Differing views were presented on both issues, and the Commission has determined to defer action in these areas. With respect to customer opt-out of segregation, most parties commenting on the issue urged the Commission to consider thoroughly the potential implications with respect to the bankruptcy rules, *e.g.,* priority of distribution, before proceeding on the issue. (CL 22–18 at 1; CL 22–22 at 6; CL 22–25 at 7; CL 22–31 at 7–8; CL 22–32 at 14–15; CL 22–34 at 3) NFA further expressed the view that there was no current need for, or interest in, allowing institutional customers to opt out of segregation, as the FCM community is more interested in being able to provide customers with a unified account statement reflecting their holdings across all products, not just futures contracts. (CL 22–24 at 5)

In response to the Commission's query on whether the types of permissible instruments held in the same customer account should be expanded, FIA expressed the view that Section 4d(2) of the Act permits the Commission to authorize any FCM that wishes to carry a customer's cash, OTC derivatives, securities and futures positions in a single account to maintain that account as a customer segregated account. The CBT cautioned the Commission to give further consideration to bankruptcy implications before proceeding in this area. The Commission agrees that action on this issue should be deferred to allow for additional study and consultation with other regulators, including members of the President's Working Group (PWG), and in addition, that any ultimate determination must be made in conjunction with deciding the customer opt-out of segregation issue.[47]

3. Investment of Customer Funds

The Commission proposed to amend Rule 1.25, which sets forth the types of instruments in which FCMs and clearing organizations are permitted to invest customer funds pursuant to Section 4d(2) of the Act (permitted investments), by expanding the list of permitted investments.[48] Previously, an FCM or clearing organization was permitted to invest segregated funds only in obligations of the U.S., in general obligations of any State or of any political subdivision thereof, or in obligations fully guaranteed as to principal and interest by the U.S.

The Commission proposed, subject to specific risk-limiting features, to permit FCMs to invest customer segregated funds in the following additional instruments: (1) Obligations issued by any agency sponsored by the U.S.; (2) certificates of deposit issued by a bank, as defined in Section 3(a)(6) of the Securities Exchange Act of 1934, or a domestic branch of a foreign bank insured by the Federal Deposit Insurance Corporation; (3) commercial paper; (4) corporate notes; and (5) interests in money market mutual funds (MMMFs). In addition, an FCM or a clearing organization would also be permitted to both buy and sell the permitted investments pursuant to agreements for resale or repurchase of the instruments (repurchase transactions).[49]

The Proposing Release contained several provisions intended to minimize credit risk, market risk, and liquidity risk, including: (i) A requirement that the investments be highly-rated by a nationally-recognized statistical rating agency (NRSRO), except for U.S. government securities and those MMMFs that are not required to be rated; (ii) a requirement that the dollar-weighted average of the time remaining to maturity of the debt securities held in the segregated portfolio not exceed 24 months, excluding investment in MMMFs because MMMFs have no maturity date; (iii) concentration limits on the percentage of the portfolio that may be comprised of the securities of individual issuers; (iv) specific prohibitions against leverage, embedded derivatives, and options; and (v) a requirement that the daily value and gains and losses on each investment be included in the records of the FCM or clearing organization.[50]

In connection with the proposed revisions to Rule 1.25, the Commission also proposed to amend Rules 1.20(a) and 1.26(a) to eliminate the requirement that an FCM obtain a written acknowledgment, from each clearing organization where the FCM has deposited customer funds or instruments purchased with customer funds, that the clearing organization was informed that the customer funds or instruments purchased with customer funds and deposited therein belong to customers and are being held in accordance with the provisions of the Act and the rules and orders promulgated thereunder.[51] The elimination of the written acknowledgment requirement would be conditioned upon the clearing organization's adoption and submission to the Commission of rules that provide for the segregation as customer funds, in accordance with the Act and the Commission's rules and orders, of all funds held on behalf of customers and all instruments purchased with customer funds.[52]

In general, commenters responded favorably to the Commission's proposals to expand the permissible investments, and the Commission has determined to adopt the amendments generally as proposed.[53] Notwithstanding their overall support, however, commenters addressed several areas in which they sought additional adjustments or clarifications concerning the rule amendments. Commenters also responded to specific questions raised by the Commission in the Proposing Release.

The CBT suggested that the Commission set guidelines with regard to the marketability of the permitted investments. The CBT recommended that the guidelines limit permitted investments to those instruments for which there are available quotes or valuations and, further, that the guidelines provide that there be a likelihood that any permitted investments can be liquidated within a

[46] 65 FR at 39014.

[47] The Commission notes, however, that cross-margining arrangements are already in place with respect to trading of stock index options and stock index futures.

[48] 65 FR at 39014.

[49] *Id.*

[50] *Id.* at 39014–15.

[51] *Id.* at 39015.

[52] *Id.* This codifies a staff no-action letter issued three years ago. *See* CFTC Staff Letter No. 97–45, [1996–1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶27,085 (May 5, 1997).

[53] Because the Commission has determined to include MMMFs in the list of permissible investments for customer funds, subject to the limitations adopted in Rule 1.25, it is hereby rescinding Division of Trading and Markets Financial and Segregation Interpretation No. 9, which previously prohibited such investment. *See* Financial and Segregation Interpretation No. 9, 1 Comm. Fut. L. Rep. (CCH) ¶7,119 (Nov. 23, 1983).

reasonable time period. (CL 22–25 at 7) The final rule has been modified so that paragraph (b)(1) of Rule 1.25 requires that the permitted securities held in segregation be ''readily marketable'' consistent with SEC Rule 15c3–1 under the Securities Exchange Act of 1934.[54]

The CBT also recommended that the Commission use a simpler approach for the valuation of downgraded investments than the proposed 20 percent per day reduction. The CBT suggested instead that a set number of days be permitted for disposal of the investment and that, during that permitted time period, the firm be allowed to use the full market value of the instrument towards meeting its segregated liability. The CBT also indicated that it thought the 20 percent per day reduction in value for a downgraded instrument could lead to errors in calculation. (CL 22–25 at 7–8) The Commission has determined not to change this provision because it believes that the 20 percent per day write-down will provide an appropriate valuation under the circumstances and that it will serve as an incentive for the firm to take action to dispose of a downgraded investment sooner. *See* Rule 1.25(b)(2)(ii).

Rosenthal Collins Group, LLC (RCG) stated that the proposed credit rating requirements were too restrictive. (CL 22–18 at 2) The Commission notes that these requirements are intended to result in the holding of ''investment grade'' securities only. After the new rule takes effect, the Commission plans to monitor the effectiveness of the rule on an ongoing basis. If experience shows that the required ratings are too stringent, adjustments to the rule will be considered.

RCG also stated that the Commission should not impose rating requirements on investments in municipal securities because some of these securities are not rated due to the costs associated with obtaining a rating. RCG stated further that if the rule were adopted as proposed, investments that comply with the present rules but that do not comply with the new requirements should be ''grandfathered'' as part of an existing portfolio. (CL 22–18 at 2) In response to this comment, the Commission will not require the disposal of investments held as of December 13, 2000, *i.e.,* such investments may be held until they mature or are liquidated in the ordinary course of business, although no new acquisitions of non-compliant investments will be permitted.

Brown Brothers Harriman (BBH) stated that the prohibition against an FCM investing in an MMMF that has investments in securities issued by a parent or affiliate of the FCM should be dropped. (CL 22–20 at 5) This recommendation was made because MMMFs are often operated independently of the sponsoring affiliated entity and, in any event, are subject to a five percent concentration limit in the securities of any single issuer. BBH also noted that many FCMs are affiliated with world-class financial enterprises and that a prohibition against MMMFs investing in securities of the FCMs' affiliates would eliminate a large and important group of instruments. The Commission finds merit in this suggestion and has modified Rule 1.25(b)(6)(ii) accordingly. The Commission also notes that Section 17 of the Investment Company Act[55] restricts investments made by MMMFs in securities issued by any entity affiliated with the MMMF or its sponsors, and that the concentration limit set forth in SEC Rule 2a–7 under the Investment Company Act[56] is similar to the concentration provision of CFTC Rule 1.25.

BBH also requested that the requirement that a fund be ''SEC registered'' be defined to mean registration under the Investment Company Act only and not require registration under the Securities Act of 1933. (CL 22–20 at 6) This clarification has been made to paragraph (c)(1) of Rule 1.25.

Sentinel Management Group, Inc. (Sentinel) requested clarification as to whether the concentration limits provided for in the proposed rule would apply to securities held in connection with repurchase agreements. (CL 22–41 at 1) Sentinel stated that the concentration limits should not apply because of: (1) The burden that would be imposed upon the FCMs; (2) the fact that complete information on such securities is sometimes not known until the day following entry into the repurchase transaction; (3) the fact that the duration of repurchase transactions is only one day; and (4) the fact that the obligation created pursuant to a repurchase transaction is that of the counterparty and not the issuer of the securities. Therefore, it argued, the creditworthiness of the counterparty augments the value of the securities held pursuant to the repurchase agreement. (CL 22–41 at 1–2) This same point was raised by BBH in follow-up conversations.

Taking into consideration these comments, as well as the requirement contained in the Proposing Release that counterparties for repurchase transactions must be regulated financial institutions (generally large banks or brokerage firms), the Commission has concluded that the focus of concentration should be primarily upon the counterparties and secondarily upon the securities held in connection with the repurchase agreement. Therefore, the final rule contains several clarifying or enhancing changes.

First, paragraph (b)(4)(ii) provides that securities that are held by a counterparty, *i.e.,* securities that have been ''repoed out,'' are subject to the concentration limitations along with currently-owned direct investment securities. This clarification was made because a security that has been sold subject to repurchase at a later date presents the FCM or clearing organization with the same price risk as a security that is currently held in the portfolio. Second, paragraph (b)(4)(iii) provides concentration limit percentages for securities that are held by the FCM or clearing organization pursuant to a reverse repurchase agreement that are double those required for direct investments, provided that the counterparty has a credit rating of single A or higher from two or more NRSROs. In addition, the rule was changed to provide that the concentration percentages for such securities shall be computed using only the securities contained in the portfolio of securities supplied by each counterparty of the FCM or clearing organization. This change was made because the counterparty has the direct control over what specific securities will be supplied in a repurchase transaction. Thus, the Commission expects that an FCM or clearing organization will inform its counterparties as to the per-issuer concentration limits that must be observed, as set forth in the rule. Finally, paragraph (b)(4)(v) makes explicit that the concentration limits do not apply to securities owned by customers that have been posted by customers as collateral with the FCM. This clarification was made primarily because changes in the value of customer-owned securities accrue to the customers who posted the securities and, therefore, in a properly margined account such securities pose no direct price risk to the FCM. The Commission believes that these changes and clarifications will provide additional flexibility to FCMs and clearing

[54] 17 CFR 240.15c3–1. As a result of the addition of new Rule 1.25(b)(1), proposed paragraph (b)(6) of Rule 1.25 concerning recordkeeping is being adopted unchanged as paragraph (b)(7).

[55] 15 U.S.C. 80a–17.

[56] 17 CFR 270.2a–7.

organizations without unduly increasing associated risk.

The Investment Company Institute (ICI) suggested that MMMFs sponsored by investment advisers registered under the Investment Advisers Act of 1940 be included in the list of permitted investments. (CL 22–27 at 6) The Commission has made this suggested change. *See* Rule 1.25(c)(2).

ICI noted that the proposed rule appeared to require valuation of the investment portfolio by 9 a.m. each day and suggested, instead, that valuation not be required until after the close of the markets each day, *i.e.,* not until after 4 p.m. (CL 22–27 at 7) The Commission's intention was to require valuation by 9 a.m. the business day following the investment, so that the valuation would be available in time for the segregation calculation, which is required to be completed on a daily basis by noon the following business day. The final rule (paragraph (c)(4) of Rule 1.25) has been changed to correctly state the Commission's intention more precisely.

ICI also suggested that the proposed rule should be changed to permit MMMFs that are not rated by an NRSRO to invest in unrated securities. The proposed rule provided that only MMMFs that are rated may invest in unrated securities. ICI cited the comprehensive approach to risk control and preservation of capital contained in SEC Rule 2a–7 and noted that that rule permits an MMMF to invest in unrated securities if the MMMF determines that the securities are of comparable quality to otherwise eligible securities. (CL 22–27 at 4) The Commission has changed the final rule (Rule 1.25(b)(2)(i)(D)) to permit unrated MMMFs to invest in unrated securities because of the risk-limiting features of SEC Rule 2a–7.

ICI also recommended two revisions to paragraph (c)(3) of Rule 1.25 concerning MMMFs. First, because fund shares are usually uncertificated, ICI recommended that the first sentence be revised to provide that the ownership of fund shares must be noted (by book-entry or otherwise) in a custody account of the FCM or clearing organization. Second, to ensure that confirmations for transactions in fund shares are retained, ICI recommended that the confirmation relating to the purchase be retained in the FCM's or clearing organization's records. (CL 22–27 at 6) The Commission has made these suggested changes.

ICI further recommended that the one-day liquidity requirement applicable to MMMFs be extended to seven days, to be consistent with SEC requirements and the longer settlement time-frames associated with direct investments. (CL 22–27 at 7)

The Commission believes the one-day liquidity requirement for investments in MMMFs is necessary to ensure that the funding requirements of FCMs will not be impeded by a long liquidity time frame. Since a material portion of an FCM's customer funds could well be invested in a single MMMF, this is an important provision of the rule. The Commission notes that, although sales of directly-owned securities settle in longer than one-day time-frames, an FCM or clearing organization could obtain liquidity by entering into a repurchase transaction. Therefore, the Commission has retained the one-day liquidity requirement imposed on investments in MMMFs and, in view of the importance of this provision, has clarified that demonstration that this requirement has been met may include either an appropriate provision in the offering memorandum of the fund or a separate side agreement between the fund and an FCM or clearing organization. *See* Rule 1.25(c)(5).

The FRBC commented that permitted investments should have either a CUSIP or ISIN number, and that permitted investments should be required to have a reasonably transparent secondary market enabling accurate and efficient valuation of the investments. (CL 22–30 at 6) The Commission has changed the final rule to include securities with ISIN numbers as permitted investments.

The FRBC also recommended that permitted investments have a reasonably transparent secondary market. As noted above, the Commission strengthened the rule in this respect by adding a requirement that all permitted securities, except for MMMFs, meet the SEC's ''readily marketable'' standard. The Commission intends to monitor closely for any problems concerning valuation of permitted investments, and will consider proposing further rule amendments if appropriate.

The FRBC also recommended that permitted investments should settle on a same-day or next-day basis, to ensure adequate liquidity. It pointed out that, currently in the U.S., virtually all corporate and municipal debt securities settle on a T+3 basis, which is not sufficient for futures clearing organization demands, and that this delay could deprive the FCM or clearing organization of the liquidity that is so important in times of market stress or emergency. (CL 22–30 at 5) The Commission has elected to permit investment of customer funds in investment grade corporate notes and municipal securities because FCMs have methods of obtaining liquidity other than by selling the securities, such as by entering into repurchase transactions and by establishing backup bank lines of credit using the securities as collateral.

The FRBC further recommended that CFTC rules should permit the investment of customer funds held in a foreign currency in identically-denominated sovereign debt securities. (CL 22–30 at 4–5; *see also* CL 22–31 at 9; CL 22–42 at 2) The Commission notes that, under the rule as proposed, an FCM that decided to invest deposits of foreign currencies was required to convert the foreign currencies received to a U.S. dollar-denominated asset. This would increase its exposure to foreign currency fluctuation risk, unless it incurred the additional expense of hedging. Therefore, the Commission has determined that the FRBC's suggestion should be adopted. The Commission has changed the proposed rule to permit investment in the general obligations of any country whose sovereign debt is rated in the highest category by at least one NRSRO, but limited as follows: an FCM may invest in the sovereign debt of a country to the extent it has balances owed to its customers denominated in that currency; a clearing organization may invest in the sovereign debt of a country to the extent it has balances owed to its clearing member FCMs denominated in that currency.[57] The Commission notes that foreign sovereign debt that is denominated in the Euro will qualify as a permitted investment under this rule, provided the country that issued the debt qualifies as a permitted country under the rule, the obligation is a general obligation of the country, and the balances owed to the customers or the FCMs are Euro-denominated. As with other aspects of Rule 1.25, the Commission will monitor the effect of this provision and stands ready to make additional adjustments as experience dictates.

In addition, the FRBC suggested that the CFTC expressly approve the use of certain ''sweep'' accounts in connection with the investment of customer funds in MMMFs or other permissible forms of investment. (CL 22–30 at 6) The Commission notes that Rule 1.25 will not preclude the use of sweep accounts and encourages this practice to enhance the efficiency of liquidity management.

The FRBC also suggested that, with respect to the concentration provision, the rule should be clarified that it applies only to the portfolio of securities

[57] As is the case for U.S. government securities and those MMMFs that are not required to be rated, permitted foreign sovereign debt will not be subject to a credit rating requirement. *See* § 1.25(b)(2)(i)(A).

purchased with customer funds, *i.e.,* the provision does not apply to customer-owned securities posted as margin. (CL 22–30 at 6) As noted previously, the Commission has made this clarification in paragraph (b)(4)(v) of Rule 1.25.

FIA suggested that the Commission clarify what is meant by the required ratings in the rule, where the ''two highest ratings of an NRSRO'' are specified, *i.e.,* AAA and AA. In particular, it recommended that the Commission clarify whether ''AA'' includes all variations included within the AA rating. (CL 22–31 at 8) The Commission confirms that this interpretation is correct.

FIA also suggested that the Commission clarify whether a security would be a permitted investment if one NRSRO gave it an acceptable rating, even though another NRSRO gave it an unacceptable rating. (CL 22–31 at 9) The Commission hereby confirms that if one NRSRO gave an acceptable rating and another did not, investment in the security would be permitted. The Commission believes that it would be rare for such differences to occur at the investment grade ratings level and, further, that any differences would probably be temporary.

FIA also suggested providing a grace period for FCMs or clearing organizations that find themselves in violation of the concentration limits. (CL 22–31 at 9) The Commission has decided against adopting this suggestion because the Commission would not expect FCMs to violate the concentration limits, except perhaps under unusual circumstances. Further, the Commission is concerned that were a formal grace period provided in the rule, it might be subject to abuse.

In addition, FIA suggested that the Commission plan to review the list of permitted investments every six months to determine whether revisions should be made. (CL 22–31 at 9) The Commission plans to review all aspects of the new rule on an ongoing basis and further changes will be proposed, if appropriate.

Two exchanges, the NYMEX and the CME, pointed out that each clearing organization would need to make its own determination as to the types of assets that would be accepted by that clearing organization. (CL 22–32 at 16; CL 22–35 at 13) The Commission recognizes that an SRO may adopt more restrictive requirements than those set forth in Rule 1.25 for its member FCMs.

E. Core Principle Four: Risk Disclosure and Account Statements

Although the Commission stated in the Proposing Release that non-institutional customers should continue to receive the risk disclosures regarding futures and options trading that are currently required,[58] it proposed to streamline the account opening process by amending Rules 1.55(d)(1) and (2) to expand the list of disclosures and consents that could be provided in a single document and acknowledged with a single signature.[59] This list includes: (1) The disclosures required by new Rule 1.33(g) (relating to electronic transmission of statements);[60] (2) the consent referenced in Rule 155.3(b)(2) (relating to customer permission for FCMs to take the opposite side of an order); and (3) a provision for preauthorization of transfers of funds from a customer's segregated account to another account of that customer. The single signature could be made electronically as provided for in recently-adopted Commission Rules 1.3(tt) and 1.4.[61] Disclosure concerning arbitration of disputes, however, would continue to require a separate signed acknowledgement by non-institutional customers, pursuant to proposed Rule 166.5 (which was modeled on, and would replace, prior Rule 180.3).[62]

All of the commenters who addressed the proposed amendments to Rule 1.55(d) responded favorably to the expansion of disclosures and consents that could be acknowledged and made by a single signature, and the Commission is adopting the amendments as proposed. (CL 22–17 at 3; CL 22–24 at 6; CL 22–25 at 8; CL 22–31 at 14; CL 22–32 at 16; CL 22–35 at 11; CL 22–44 at 2) FIA requested that the Commission confirm that an FCM may obtain an acknowledgement of receipt and understanding of the risk disclosure statement contemporaneously with opening an account. The Commission agrees that the FCM may open the customer account simultaneously with receiving the acknowledgment of receipt and understanding of the risk disclosure statement, along with margin funds and any other required account opening documents, from the customer. The FCM will remain responsible for ensuring that the risk disclosure document is furnished to the customer in such a way that the customer can review and understand the document before committing funds to the FCM.

NFA commented generally that the Commission should not dictate the specifics of how disclosures and consents are delivered and acknowledged, and that it would be willing to develop best practice guidance in this area. (CL 22–24 at 6) The Commission believes that its rules requiring risk disclosure and customer acknowledgments do not impose a significant burden in light of their important customer protections. The Commission is providing additional flexibility to the industry in this area. As the Commission noted in the Proposing Release, there would continue to be no specific disclosure requirements for institutional customers and, in addition, as provided in Rule 35.1(b), governmental entities would be included in the definition of ''institutional customer,'' and consequently would not be required to receive and to acknowledge a disclosure statement.[63] Further, the single signature acknowledgment could be made electronically as provided for in Rules 1.3(tt) and 1.4. The Commission looks forward to working with NFA and the industry both in developing a Statement of Acceptable Practices for disclosure to non-institutional customers trading on DTFs, and in developing more streamlined disclosure requirements for domestic exchange-traded options under Rule 33.7.

As noted above, the Commission proposed to continue to require a separate signed acknowledgement by non-institutional customers with respect to disclosure concerning arbitration of disputes. Nevertheless, the Commission also solicited comment on whether to maintain this requirement.[64] FIA opposed continuing to require a separate signature from non-institutional customers if their account agreement contains a pre-dispute arbitration provision. (CL 22–31 at 14) In general, FIA expressed the opinion that the Commission should eliminate all of its rules pertaining to the use of pre-dispute arbitration agreements, as well as the Commission's reparations program. For example, FIA commented that the Commission's rule that an FCM may not require a customer to sign a pre-dispute arbitration agreement as a condition to opening an account with the FCM inhibits the ability of FCMs that are also securities broker-dealers to enter into a single agreement with their customers, because the SEC does not prohibit the use of such mandatory agreements. (CL 22–31 at 10) At the very least, FIA stated that the Commission

[58] 65 FR at 39015. There would continue to be no specific disclosure requirements for institutional customers. Id. at 39016.

[59] *Id.* at 39015–16.

[60] *See infra.*

[61] 65 FR 12466 (Mar. 9, 2000).

[62] 65 FR at 39016. This is discussed further below.

[63] *Id.*

[64] *Id.*

should permit institutional customers contractually to waive their right to file a complaint under the Commission's reparations program. (CL 22–31 at 10) In this regard, NFA maintained that intermediaries and institutional customers should be allowed to negotiate *all* terms in pre-dispute arbitration agreements. (CL 22–24 at 8).

The Commission is adopting Rule 166.5 as it pertains to non-institutional customers as proposed. Further, the Commission believes that no customer, regardless of their level of sophistication, should be required to sign a pre-dispute arbitration agreement as a condition for doing business in the futures industry. The Commission has determined, however, to allow institutional customers and intermediaries to negotiate any terms of a pre-dispute arbitration agreement as they deem appropriate, including a waiver of the customer's right to file a complaint under the Commission's reparations program. Accordingly, the definition of the term ''customer'' in Rule 166.5(a)(2) has been changed to exclude institutional customers from general application of the rule. In addition, new paragraph (g) has been added to make clear that an institutional customer and a registrant may negotiate any terms of a pre-dispute arbitration agreement, except that the institutional customer may not be required to sign a pre-dispute arbitration agreement as a condition of opening an account with the registrant.[65]

NFA specifically requested that the Commission clarify the reach of pre-dispute arbitration agreements and confirm that such agreements are binding on both the intermediary as well as the customer, unless the agreement states specifically that the registrant is not required to arbitrate its claims.[66] (CL 22–24 at 9) Former Part 180, which is to be replaced by Rule 166.5, was mainly intended to provide for fair and equitable SRO arbitration forums and to prevent firms from requiring customers to agree to arbitration in order to do business. Part 180 did not require registrants to submit their claims against customers to arbitration, and the Commission did not propose to require that registrants do so in the Proposing Release. Thus, provided that a registrant pursues a dispute in accordance with the terms of the customer agreement, and the procedures followed do not violate Rule 166.5, Commission rules would not prohibit the registrant's actions.

NFA also objected to proposed Rule 166.5(f), which would permit counterclaims that do not arise out of the same transaction or occurrence that is the subject of the original claim only if (1) The customer agreed to the counterclaim being heard after it has arisen, and (2) the aggregate monetary value of the counterclaim is capable of calculation. NFA believes that, for both retail and institutional customers, the parties should be allowed to agree in advance that any counterclaim would be required to be included in the arbitration proceeding. (CL 22–24 at 9) The Commission has determined to adopt NFA's suggestion, and has revised Rule 166.5(f) to permit any counterclaim arising out of a transaction subject to the Act and Commission regulations promulgated thereunder for which a non-institutional customer has utilized the services of a registrant, to be made part of an arbitration proceeding between the non-institutional customer and the registrant where the parties have agreed in advance to require that any such claim be included in the arbitration proceeding, provided that the aggregate monetary value of the counterclaim is capable of calculation. As noted above, under Rule 166.5(g), institutional customers remain free to negotiate any terms of their pre-dispute arbitration agreement, including the type of counterclaims that may be included in an arbitration proceeding.

F. Core Principle Five: Trading Standards

The Commission proposed that Rules 155.1, 155.3 and 155.4, which collectively require FCMs and IBs to establish and to maintain supervisory procedures to assure that neither they nor any affiliated persons use their knowledge of customer orders to the customer's disadvantage, would continue to apply to intermediation of trades on contract markets. These requirements would be extended to trading on RFEs, and to trading by non-institutional customers on DTFs under new Rule 155.6(a).[67] These rules over the years have helped the Commission deter such practices as ''front-running,'' ''trading ahead,'' ''bucketing,'' taking the opposite side of customer orders, and improper disclosure of customer orders. However, for intermediation of trades by institutional customers at DTFs, the Commission proposed a new Rule 155.6(b), which set forth a general standard of practice in this area that parallels the language of the core principle concerning trading standards. The Commission stated that ''it is nevertheless intended to proscribe the same trade practice abuses as Rules 155.1–155.5.'' [68]

The commenters who addressed this section were critical of the Commission's approach. The CBT expressed its belief that all prescriptive rules regarding trading practices should be replaced with core principles, not just the rules governing trades for institutional customers on DTFs. (CL 22–25 at 8) MFA stated that it was inconsistent to add a general prohibition against ''misuse'' of knowledge as contained in Proposed Rule 155.6(b) if the rule was intended to proscribe the same trade practice abuses referred to in Rules 155.1–155.5. (CL 22–22 at 13–14) NFA commented that RFEs and DTFs should not be treated differently with respect to trading standards rules, because otherwise operators of DTFs would have a competitive advantage over operators of RFEs. (CL 22–24 at 6)

The Commission has determined to leave unchanged Rules 155.1–155.5 at this time, and to adopt Rule 155.6 as proposed. The Commission believes that the existing rules should continue to apply in connection with non-institutional customer trades no matter where they occur because of such customers' greater susceptibility to trading abuses by intermediaries, as compared to institutional customers. The Commission recognizes that, with respect to institutional customers trading on a DTF, a general standard of practice is more appropriate. However, the Commission remains open to specific suggestions regarding how individual provisions in Rules 155.3 and 155.4 might be streamlined.

The Commission notes that because the core principle concerning trading standards states that intermediaries must not misuse their knowledge of their customers' orders without making any distinctions regarding the nature of the customer, the same trade practice abuses that are proscribed by Rules 155.1–155.5 should also be considered

[65] As a result of these changes, proposed paragraphs (c)(2) (ii) and (iii) of Rule 166.5 are adopted as paragraphs (c)(2) (i) and (ii), respectively. In addition, to reflect the recent amendments to Rule 4.7, paragraph (c)(2)(ii) of Rule 166.5 (formerly paragraph (c)(2)(iii)) has been modified to apply to a person who is a ''qualified eligible person'' as defined by Rule 4.7. *See* 65 FR 47848 (Aug. 4, 2000).

[66] NFA referred to several recent lower court cases where registrants who brought debit balance claims against their customers in state court successfully argued, in response to the customers' attempts to force the claims to arbitration, that a pre-dispute arbitration agreement did not apply to their claims against customers. NFA questioned the logic of these decisions, stating that there is no consideration for a customer to sign a pre-dispute arbitration agreement if it does not apply to the intermediary's claims as well. (CL 22–24 at 9)

[67] 65 FR at 39016.

[68] *Id.*

as being in violation of Rule 155.6(b). The Commission believes that its overall approach with respect to trading standards strikes a reasonable balance in preserving rules that have worked successfully over the years in curbing abusive trading practices, while relaxing certain of the specific provisions of the existing rules in connection with the trading on DTFs by more sophisticated customers.

G. Core Principle Seven: Reporting Requirements

The Commission proposed to apply its existing large trader reporting requirements to intermediaries on RFEs, but would reduce reporting requirements with respect to intermediaries transacting business on DTFs, because of the nature of the instruments traded or the limited access granted to non-institutional traders. Intermediaries trading on DTFs would be subject to large trader reporting requirements only by special call.

The Commission received varying comments in response to its large trader reporting proposal. NFA agreed with both aspects of the Commission's proposal, asserting that large trader reporting requirements should remain in place for intermediaries on RFEs, while a more flexible approach would be appropriate for gathering information from intermediaries trading on DTFs. (CL 22–24 at 7) FC Stone suggested that reduced large trader reporting should be available to all FCMs with institutional customers only, not just to those trading on DTFs. (CL 22–44 at 4) The CBT stated that the Commission should permit individual markets to require large trader reporting, as they deem necessary, and that any large trader reporting to the Commission should be done pursuant to special call, without drawing a distinction between DTFs and RFEs. (CL 22–25 at 8–9) NIBA also commented that the Commission should not make a distinction between DTFs and RFEs; NIBA stated, however, that regular large trader reports should be required on both types of exchanges, and that otherwise customers who trade on RFEs would lose the benefit of price transparency. (CL 22–17 at 4) Treasury expressed concern about the mechanics of large trader reporting on a DTF, stating that because eligible participants would not be required to use FCMs to execute trades on a DTF, it was unclear how large trader positions could be reported. In addition, Treasury noted that large trader reporting requirements have worked well in the market for Treasury bond futures, both for the information they reveal to regulators and their deterrent effect, and consequently, urged the Commission to establish a mechanism for large trader reporting for government securities futures trading on DTFs. (CL 22–34 at 4) The Economic Strategy Institute agreed with Treasury that the elimination of large trader reports would reduce the Commission's ability to effectively detect and deter manipulation. (CL 22–45 at 2) Finally, the American Farm Bureau Federation, the American Soybean Association, the National Association of Wheat Growers, the National Cattlemen's Beef Association, the National Corn Growers Association, the National Farmers Union, the National Grain Sorghum Producers and the National Pork Producers Council collectively commented that if the Commission determined to permit agricultural products to be traded on a DTF, large trader reports relating thereto should be filed with the Commission. (CL 22–51 at 1)

The Commission has determined to adopt the large trader reporting requirements for RFEs and DTFs as proposed, except that large trader reports will not be required from participants trading on a commercial-participant DTF. The reporting system is critical to the Commission's ability to oversee markets and provides a valuable bulwark against illegitimate trade practices. RFEs in particular permit unconditioned access to any type of trader, including both institutional and non-institutional customers or participants, and may list contracts on any type of commodity, including those based on commodities that have finite deliverable supplies or cash markets with limited liquidity. Such markets potentially have a greater susceptibility to price manipulation and raise greater customer protection concerns than do DTFs. Consequently, regular large trader reports are necessary to enable the Commission to carry out its oversight responsibilities for RFE markets.

With respect to intermediaries transacting business on DTFs, however, because of the nature of the instruments traded and the limited access granted to non-institutional traders, large trader reporting on a less routine basis, *i.e.*, upon special call by the Commission, is more appropriate. Where trading access on a DTF is restricted to eligible commercial participants only, however, large trader reports generally will not be required from such participants.[69] The Commission will rely instead on its investigative authority, which also applies to a person's cash market activities.[70]

H. Core Principle Eight: Recordkeeping

1. General

The Core Principles state that all registrants must keep full books and records of their activities related to their business. Thus, the Commission did not propose to amend any of its recordkeeping requirements in the Proposing Release.[71] NFA asked the Commission to consider replacing Rule 1.31 with a core principle and acceptable practice guidance that follows NFA's December 1997 proposal. NFA's proposal recommended that Rule 1.31 be rewritten to require only that registrant recordkeeping systems meet general reliability and accessibility standards. (CL 22–24 at 7) The Commission revised Rule 1.31 in 1999 to provide additional flexibility to recordkeepers, allowing them to store most required records on either micrographic or electronic storage media for the full five-year required retention period.[72] The Commission intends to revisit NFA's proposal in the future and, where appropriate, will undertake to work with the SEC to make additional changes in this area.

2. Customer Account Statements; Close-Out of Offsetting Positions

The Commission proposed to codify its June 1997 advisory relating to the electronic transmission of account statements in a new Rule 1.33(g).[73] Thus, an FCM would be permitted, with customer consent, to deliver required confirmation, purchase-and-sale, and monthly account statements electronically in lieu of mailing a paper copy. FCMs would need only to retain the daily confirmation statement as of the end of the trading session, provided that it reflects all trades made during that session. Before transmitting any statement electronically to a customer, however, the FCM would be required to make certain disclosures regarding the practice, and in the case of non-institutional customers, the FCM would be required to obtain the customer's signed consent acknowledging the disclosures. The acknowledgement could be made through a single signature in accordance with Rule 1.55 as discussed above. NIBA and FC Stone responded favorably to the

[69] As explained in a companion release in today's edition of the **Federal Register**, large trader reports may be required upon special call depending upon the nature of the commodity interest traded on a commercial-participant DTF.

[70] Large trader reports may be required upon special call on the DTF itself, however. *See* § 37.6(a).

[71] 65 FR at 39017.

[72] 64 FR 28735.

[73] 65 FR at 39017; *see also* 62 FR 31507 (June 10, 1997).

Commission's proposal (CL 22–17 at 3; CL 22–44 at 2), while NFA commented that the 1997 Advisory should be treated as acceptable practices guidance rather than codified in a new rule. (CL 22–24 at 7) The Commission has determined to adopt the rule as proposed, believing that, as noted previously, a certain level of uniformity and standardization is essential in an area such as reporting to customers to facilitate the processing of massive quantities of data, which is often accomplished by third-party, ''back office'' firms.

The Commission also proposed to revise Rule 1.46 to allow customers or account controllers to instruct the FCM if they wished to deviate from the default rule that the FCM close out offsetting positions on a first-in, first-out basis, looking across all accounts it carries for the same customer.[74] CPOs and CTAs would be required to disclose, under proposed amendments to Rules 4.24(h)(2) and 4.34(h), respectively, if they instruct an FCM to deviate from the default rule for closing out offsetting positions.[75]

After considering the comments received, the Commission is adopting the revisions as proposed. Nevertheless, the Commission agrees with NFA that FCMs should closely monitor the activity in those customer accounts that depart from the default close-out method set forth in Rule 1.46 to ensure that their customers are not offsetting their positions other than by a first-in, first-out method solely to avoid taxes, to launder money, or to improve their delivery position. (CL 22–24 at 7)

In addition, the Commission believes that customers may transmit their offset instructions to their FCMs orally, as requested by FIA. (CL 22–31 at 8) In the case of CPOs and CTAs, the Commission agrees with MFA that responsibility for transmitting instructions regarding offset should normally lie with the registrant directing trading. Generally, where a pool's trading is directed by a CTA, this should be the CTA, not the CPO. (CL 22–22 at 14) The Commission does not agree, however, that it is unnecessary to require CPOs and CTAs to disclose whether they instructed their FCM to offset positions in a manner other than by a first-in, first-out method. The Commission does not believe that this requirement would impose a significant burden on CPOs and CTAs, particularly in light of the fact that these entities would no longer be prevented from offsetting their positions in a manner other than on a first-in, first-out basis, as was previously the case. The Commission believes that it is appropriate in this area to provide greater choice balanced with disclosure as to the method of operation.

[74] 65 FR at 39017.

[75] *Id.*

III. Section 4(c) Findings

Certain of these final rules and rule amendments 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 question 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. For the reasons stated below, the Commission believes that issuing the exemptive relief as set forth in these final rules and rule amendments is consistent with those determinations.

As explained above, certain of the final rules and rule amendments would provide greater flexibility for intermediaries and their customers in several areas. Specifically, the Commission is adopting final rule amendments concerning the definition of the term ''principal'' that recognize the evolution of management structures by reducing the number of officers that will be considered principals, while ensuring that appropriate personnel that perform significant roles within the firm remain listed as such. In addition, the Commission is expanding the range of instruments in which FCMs may invest customer funds beyond those listed in Section 4d(2) of the Act to enhance the yield available to FCMs, clearing organizations and their customers, without compromising the safety of customer funds. These final rule amendments acknowledge the development of new financial instruments over the last 60 years, and should both enable FCMs to remain competitive globally and domestically and maintain safeguards against systemic risk. In light of the foregoing, the Commission has determined that the adoption of the final rules and rule amendments relating to the definition of the term ''principal'' and the expansion of permitted instruments for the investment of customer funds will be consistent with the public interest.

Further, the final rules and rule amendments adopted herein, as well as the existing rules as they also relate to the transaction of business by intermediaries, will be applied, or extended, to agreements, contracts and transactions carried out on new markets, *i.e.,* RFEs and DTFs. As more fully discussed in a companion release published in this edition of the **Federal Register**, the rules pertaining to the new markets establish a new regulatory framework that 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 in the markets. The new framework establishes three regulatory tiers with regulations tailored to the nature of the commodities traded and the nature of the market participant, and access to each of the tiers is dependent upon the appropriateness of the participant. In this respect, the Commission believes that the actions taken herein are consistent with the ''public interest'' as that term is used in Section 4(c) of the Act. When that provision was enacted, the Conference Report accompanying the Futures Trading Practices Act of 1992[76] stated that the ''public interest'' in this context would ''include the national public interests noted in the Act, the prevention of fraud and the preservation of the financial integrity of the markets, as well as the promotion of responsible economic or financial innovation and fair competition.''[77]

[76] Pub. L. No. 102–546 (1992), 106 Stat. 3590.

[77] H.R. Rep. No. 978, 102d Cong., 2d Sess. 78 (1992). The Conference Report also states that the reference in Section 4(c) to the ''purposes of the Act'' is intended to ''underscore [the Conferees'] expectation that the Commission will assess the

Continued

The Commission has retained or adopted safeguards to ensure that transactions will be carried out between appropriate persons. Appropriate persons can include, beyond those specified in Section 4(c)(3)(A)–(J) of the Act, ''[s]uch other persons that the Commission determines to be appropriate in light of their financial or other qualifications, or the applicability of appropriate regulatory protections.'' [78] The Commission has determined that it is appropriate to permit any person to trade on an RFE because the rules pertaining to RFEs will be closest to those currently pertaining to contract markets and the bulk of the existing regulatory framework pertaining to intermediaries will apply in connection with their intermediation of transactions on RFEs. On the other hand, customers on DTFs, which will be subject to looser regulation than RFEs, are generally restricted to the types of persons specified in Section 4(c)(3)(A)–(J) of the Act. The Commission has determined, however, that it is appropriate to allow access to retail, or non-institutional, customers on DTFs, subject to stated limits and conditions. For example, if a non-institutional customer seeks to enter into transactions on a DTF permitting such access, such customer may only do so through either: a) a registered FCM that is a clearing member of at least one designated contract market or RFE, and that has adjusted net capital of at least $20 million; or b) a registered CTA who has discretionary authority over the non-institutional customer's account, and who has assets under management of not less than $25 million. The Commission further believes that, in light of these conditions and safeguards, the exemptive relief would have no adverse effect on any of the regulatory or self-regulatory responsibilities imposed by the Act.

IV. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA), 5 U.S.C. 601 *et seq.* (1994 & Supp. II 1996), requires federal agencies, in proposing rules, to consider the impact of those rules on small businesses. The rules adopted herein would affect FCMs, IBs, CPOs, CTAs, FBs, FTs, leverage transaction merchants (LTMs) and agricultural trade option merchants (ATOMs), as well as principals thereof. The Commission has previously established certain definitions of ''small entities'' to be used by the Commission in evaluating the impact of its rules on small entities in accordance with the RFA.[79] The Commission has previously determined that registered FCMs, CPOs, LTMs and ATOMs are not small entities for the purpose of the RFA.[80] With respect to IBs, CTAs, FBs and FTs, the Commission has stated that it is appropriate to evaluate within the context of a particular rule proposal whether some or all of the 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 registrant to change its current method of doing business. For many registrants, the revisions should decrease the number of persons within the registrant's organization who would be considered principals under the CFTC rules. Further, the revisions should reduce, rather than increase, the regulatory requirements that apply to registrants and applicants for registration, regardless of size. Accordingly, pursuant to 5 U.S.C. 605(b), the Chairman, on behalf of the Commission, certifies 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 concerning the RFA implications of the rules and rule amendments discussed herein.

B. Paperwork Reduction Act

As required by the Paperwork Reduction Act of 1995 [44 U.S.C. 3507(d)], the Commission submitted a copy of the proposed amendments to its rules to the Office of Management and Budget for its review. The Commission did not receive any comments on any potential paperwork burden associated with the Proposing Release.

List of Subjects

17 CFR Part 1

Brokers, Commodity futures, Consumer protection, Reporting and recordkeeping requirements.

17 CFR Part 3

Administrative practice and procedure, Brokers, Commodity futures, Principals, Registration, Reporting and recordkeeping requirements.

17 CFR Part 4

Advertising, Commodity futures, Commodity pool operators, Commodity trading advisors, Consumer protection, Disclosure, Principals, Reporting and recordkeeping requirements.

17 CFR Part 140

Authority delegations (Government agencies), Conflict of interests, Organization and functions (Government agencies).

17 CFR Part 155

Brokers, Commodity futures, Reporting and recordkeeping requirements.

17 CFR Part 166

Brokers, Commodity futures, Consumer protection, Reporting and recordkeeping requirements.

In consideration of the foregoing, and pursuant to the authority contained in the Commodity Exchange Act, and in particular, Sections 2, 4(c), 4b, 4d, 4f, 4m, 4n, 8a, and 19 thereof, 7 U.S.C. 2, 6(c), 6b, 6d, 6f, 6m, 6n, 12a and 23, the Commission hereby amends Parts 1, 3, 4, 140, 155 and 166 of Chapter I of Title 17 of the Code of Federal Regulations as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. The authority citation for Part 1 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 2a, 4, 4a, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 6p, 7, 7a, 7b, 8, 9, 12, 12a, 12c, 13a, 13a–1, 16, 16a, 19, 21, 23 and 24.

2. Section 1.3 is amended by adding new paragraphs (g), (m) and (v) to read as follows:

§ 1.3 Definitions.

* * * * *

(g) *Institutional customer.* This term has the same meaning as ''eligible participant'' as defined in § 35.1(b) of this chapter.

* * * * *

(m) *Derivatives transaction facility.* This term has the same meaning as a ''derivatives transaction facility'' under part 37 of this chapter.

* * * * *

(v) *Recognized futures exchange.* This term has the same meaning as a ''recognized futures exchange'' under part 38 of this chapter.

* * * * *

3. Section 1.10 is amended as follows:

a. Revising paragraph (a)(2)(i)(B);

b. Adding paragraph (a)(2)(i)(C);

c. Designating the undesignated paragraph following paragraph

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impact of a proposed exemption on the maintenance of the integrity and soundness of markets and market participants.'' *Id.*

[78] See Section 4(c)(3)(K) of the Act, 7 U.S.C. 6(c)(3)(K).

[79] 47 FR 18618–21 (Apr. 30, 1982).

[80] *Id.* at 18619–20 (discussing FCMs and CPOs); 54 FR 19556, 19557 (May 8, 1989) (discussing LTMs); and 63 FR 18821, 18830 (Apr. 16, 1998) (discussing ATOMs).

(a)(2)(i)(B) as paragraph (a)(2)(i)(D) and revising it;

d. Designating the undesignated paragraph following paragraph (a)(2)(ii)(C) as paragraph (a)(2)(ii)(E) and revising it;

e. Redesignating paragraph (a)(2)(ii)(C) as (a)(2)(ii)(D) and revising it; and

f. Adding a new paragraph (a)(2)(ii)(C).

The revisions and additions read as follows:

§ 1.10 Financial reports of futures commission merchants and introducing brokers.

(a) * * *

(2) * * *

(i) * * *

(B) A Form 1–FR–FCM as of a date not more than 17 business days prior to the date on which such report is filed and a Form 1–FR–FCM certified by an independent public accountant in accordance with § 1.16 as of a date not more than one year prior to the date on which such report is filed; or

(C) A Form 1–FR–FCM as of a date not more than 17 business days prior to the date on which such report is filed, *Provided, however,* that such applicant shall be subject to a review by the applicant's designated self-regulatory organization within six months of being granted registration.

(D) Each such person must include with such financial report a statement describing the source of his current assets and representing that his capital has been contributed for the purpose of operating his business and will continue to be used for such purpose.

(ii) * * *

(C) A Form 1–FR–IB as of a date not more than 17 business days prior to the date on which such report is filed, *Provided, however,* that such applicant shall be subject to a review by the applicant's designated self-regulatory organization within six months of registration; or

(D) A guarantee agreement.

(E) Each person filing in accordance with paragraphs (a)(2)(ii) (A), (B) or (C) of this section must include with such financial report a statement describing the source of his current assets and representing that his capital has been contributed for the purpose of operating his business and will continue to be used for such purpose.

* * * * *

4. Section 1.17 is amended by redesignating paragraph (a)(1)(ii) as (a)(1)(iii) and by adding new paragraphs (a)(1)(ii) and (a)(2)(iii) to read as follows:

§ 1.17 Minimum financial requirements for futures commission merchants and introducing brokers.

(a) * * *

(1) * * *

(ii) Each person registered as a futures commission merchant engaged in soliciting or accepting orders and customer funds related thereto for the purchase or sale of any commodity for future delivery on or subject to the rules of a derivatives transaction facility from any customer who does not qualify as an ''institutional customer'' as defined in § 1.3(g):

(A) Must be a clearing member of a designated contract market or recognized futures exchange, and must maintain adjusted net capital in the amount of the greater of $20,000,000 or the amounts otherwise specified in paragraph (a)(1)(i) of this section; or

(B) Receive orders on behalf of the customer from a commodity trading advisor acting in accordance with § 4.32 of this chapter.

* * * * *

(2) * * *

(iii) The requirements of paragraph (a)(1) of this section shall not be applicable if the registrant is a futures commission merchant or introducing broker registered in accordance with § 3.10(a)(1)(i)(B) of this chapter, whose business is limited to transacting business on behalf of institutional customers on a derivatives transaction facility, and who conforms to minimum financial standards and related reporting requirements set by such derivatives transaction facility in its rules.

* * * * *

5. Section 1.20 is amended by revising paragraphs (a) and (c) to read as follows:

§ 1.20 Customer funds to be segregated and separately accounted for.

(a) All customer funds shall be separately accounted for and segregated as belonging to commodity or option customers. Such customer funds when deposited with any bank, trust company, clearing organization or another futures commission merchant shall be deposited under an account name which clearly identifies them as such and shows that they are segregated as required by the Act and this part. Each registrant shall obtain and retain in its files for the period provided in § 1.31 a written acknowledgment from such bank, trust company, clearing organization, or futures commission merchant, that it was informed that the customer funds deposited therein are those of commodity or option customers and are being held in accordance with the provisions of the Act and this part: *Provided, however,* that an acknowledgment need not be obtained from a clearing organization that has adopted and submitted to the Commission rules that provide for the segregation as customer funds, in accordance with all relevant provisions of the Act and the rules and orders promulgated thereunder, of all funds held on behalf of customers. Under no circumstances shall any portion of customer funds be obligated to a clearing organization, any member of a contract market, a futures commission merchant, or any depository except to purchase, margin, guarantee, secure, transfer, adjust or settle trades, contracts or commodity option transactions of commodity or option customers. No person, including any clearing organization or any depository, that has received customer funds for deposit in a segregated account, as provided in this section, may hold, dispose of, or use any such funds as belonging to any person other than the option or commodity customers of the futures commission merchant which deposited such funds.

* * * * *

(c) Each futures commission merchant shall treat and deal with the customer funds of a commodity customer or of an option customer as belonging to such commodity or option customer. All customer funds shall be separately accounted for, and shall not be commingled with the money, securities or property of a futures commission merchant or of any other person, or be used to secure or guarantee the trades, contracts or commodity options, or to secure or extend the credit, of any person other than the one for whom the same are held: *Provided, however,* That customer funds treated as belonging to the commodity or option customers of a futures commission merchant may for convenience be commingled and deposited in the same account or accounts with any bank or trust company, with another person registered as a futures commission merchant, or with a clearing organization, and that such share thereof as in the normal course of business is necessary to purchase, margin, guarantee, secure, transfer, adjust, or settle the trades, contracts or commodity options of such commodity or option customers or resulting market positions, with the clearing organization or with any other person registered as a futures commission merchant, may be withdrawn and applied to such purposes, including the payment of premiums to option grantors, commissions, brokerage, interest, taxes,

storage and other fees and charges, lawfully accruing in connection with such trades, contracts or commodity options: *Provided, further,* That customer funds may be invested in instruments described in § 1.25.

6. Section 1.25 is revised to read as follows:

§ 1.25 Investment of customer funds.

(a) *Permitted investments.* (1) Subject to the terms and conditions set forth in this section, a futures commission merchant or a clearing organization may invest customer funds in the following instruments (permitted investments):

(i) Obligations of the United States and obligations fully guaranteed as to principal and interest by the United States (U.S. government securities);

(ii) General obligations of any State or of any political subdivision thereof (municipal securities);

(iii) General obligations issued by any agency sponsored by the United States (government sponsored agency securities);

(iv) Certificates of deposit issued by a bank (certificates of deposit) as defined in section 3(a)(6) of the Securities Exchange Act of 1934, or a domestic branch of a foreign bank that carries deposits insured by the Federal Deposit Insurance Corporation;

(v) Commercial paper;

(vi) Corporate notes;

(vii) General obligations of any country whose sovereign debt is rated in the highest category by at least one nationally recognized statistical rating organization (NRSRO), as that term is defined in § 270.2a–7 of this title (permitted foreign sovereign debt), subject to the following limits: a futures commission merchant may invest in the sovereign debt of a country to the extent it has balances in segregated accounts owed to its customers denominated in that country's currency; a clearing organization may invest in the sovereign debt of a country to the extent it has balances in segregated accounts owed to its clearing member futures commission merchants denominated in that country's currency; and

(viii) Interests in money market mutual funds.

(2) In addition, a futures commission merchant or a clearing organization may buy and sell the permitted investments listed in paragraphs (a)(1)(i) through (viii) of this section pursuant to agreements for resale or repurchase of the instruments, in accordance with the provisions of paragraph (d) of this section.

(b) *General terms and conditions.* A futures commission merchant or a clearing organization is required to manage the permitted investments consistent with the objectives of preserving principal and maintaining liquidity and according to the following specific requirements.

(1) *Marketability.* Except for interests in money market mutual funds, investments must be ''readily marketable'' as defined in § 240.15c3–1 of this title.

(2) *Ratings.* (i) *Initial requirement.* Instruments that are required to be rated by this section must be rated by an NRSRO. For an investment to qualify as a permitted investment, ratings are required as follows:

(A) U.S. government securities and the permitted sovereign debt of the countries listed in paragraph (a)(1)(vii) of this section, need not be rated;

(B) Municipal securities, government sponsored agency securities, certificates of deposit, commercial paper, and corporate notes, except notes that are asset-backed, must have the highest short-term rating of an NRSRO or one of the two highest long-term ratings of an NRSRO;

(C) Corporate notes that are asset-backed must have the highest rating of an NRSRO; and

(D) Money market mutual funds that are rated by an NRSRO must be rated at the highest rating of the NRSRO.

(ii) *Effect of downgrade.* If an NRSRO lowers the rating of an instrument that was previously a permitted investment on the basis of that rating to below the minimum rating required under this section, the value of the instrument recognized for segregation purposes will be the lesser of:

(A) The current market value of the instrument; or

(B) The market value of the instrument on the business day preceding the downgrade, reduced by 20 percent of that value for each business day that has elapsed since the downgrade.

(3) *Restrictions on instrument features.* (i) With the exception of money market mutual funds, no permitted investment may contain an embedded derivative of any kind, including but not limited to a call option, put option, or collar, cap, or floor on interest paid.

(ii) No instrument may contain interest-only payment features.

(iii) No instrument may provide payments linked to a commodity, currency, reference instrument, index, or benchmark except as provided in paragraph (b)(3)(iv) of this section.

(iv) Variable-rate securities are permitted, provided the interest rates paid correlate closely and on an unleveraged basis to a benchmark of either the Federal Funds target or effective rate, the prime rate, the three-month Treasury Bill rate, or the one-month or three-month LIBOR rate.

(v) Certificates of deposit, if negotiable, must be able to be liquidated within one business day or, if not negotiable, must be redeemable at the issuing bank within one business day, with any penalty for early withdrawal limited to any accrued interest earned according to its written terms.

(4) *Concentration.* (i) *Direct investments.* (A) U.S. government securities, money market mutual funds, and permitted foreign sovereign debt securities shall not be subject to a concentration limit.

(B) Securities of any single issuer of government sponsored agency securities held by a futures commission merchant or clearing organization may not exceed 25 percent of total assets held in segregation by the futures commission merchant or clearing organization.

(C) Securities of any single issuer of municipal securities, certificates of deposit, commercial paper, or corporate notes held by a futures commission merchant or clearing organization may not exceed 5 percent of total assets held in segregation by the futures commission merchant or clearing organization.

(ii) *Repurchase agreements.* For purposes of determining compliance with the concentration limits set forth in this section, securities sold by a futures commission merchant or clearing organization subject to agreements to repurchase shall be combined with securities held by the futures commission merchant or clearing organization as direct investments.

(iii) *Reverse repurchase agreements.* The concentration limit applicable to securities of each issuer that are held by a futures commission merchant or clearing organization subject to agreements to resell to a particular counterparty shall be as follows:

(A) For a portfolio of securities held that are subject to resale to a counterparty that has been rated single A or higher by two or more NRSROs, or whose obligation under an agreement is guaranteed by a parent or affiliate company that has been rated single A or higher by two or more NRSROs:

(*1*) Government sponsored agency debt, issued by the same issuer and supplied by the counterparty, may not exceed 50 percent of the total amount of securities supplied by such counterparty; and

(*2*) Municipal securities, certificates of deposit, commercial paper, and corporate notes, issued by the same issuer and supplied by the counterparty,

may not exceed 10 percent of the total amount of securities supplied by such counterparty; and

(B) For a portfolio of securities held that are subject to resale to a counterparty that does not have a rating or guarantee as specified in paragraph (b)(4)(iii)(A) of this section:

(*1*) Government sponsored agency debt, issued by the same issuer and supplied by the counterparty, may not exceed 25 percent of the total amount of securities supplied by such counterparty; and

(*2*) Municipal securities, certificates of deposit, commercial paper, and corporate notes, issued by the same issuer and supplied by the counterparty, may not exceed 5 percent of the total amount of securities supplied by such counterparty.

(iv) *Treatment of securities issued by affiliates.* For purposes of determining compliance with the concentration limits set forth in this section, securities issued by entities that are affiliated, as defined in paragraph (b)(6) of this section, shall be aggregated and deemed the securities of a single issuer. An interest in a permitted money market mutual fund is not deemed to be a security issued by its sponsoring entity.

(v) *Treatment of customer-owned securities.* For purposes of determining compliance with the concentration limits set forth in this section, securities owned by the customers of a futures commission merchant and posted as margin collateral are not included in total assets held in segregation by the futures commission merchant, and securities posted by a futures commission merchant with a clearing organization are not included in total assets held in segregation by the clearing organization.

(5) *Time-to-maturity.* Except for investments in money market mutual funds, the dollar-weighted average of the time-to-maturity of the portfolio, as that average is computed pursuant to § 270.2a–7 of this title, may not exceed 24 months.

(6) *Investments in instruments issued by affiliates.* (i) A futures commission merchant shall not invest customer funds in obligations of an entity affiliated with the futures commission merchant, and a clearing organization shall not invest customer funds in obligations of an entity affiliated with the clearing organization. An affiliate includes parent companies, including all entities through the ultimate holding company, subsidiaries to the lowest level, and companies under common ownership of such parent company or affiliates.

(ii) A futures commission merchant or clearing organization may invest customer funds in a fund affiliated with that futures commission merchant or clearing organization.

(7) *Recordkeeping.* A futures commission merchant and a clearing organization shall prepare and maintain a record that will show for each business day with respect to each type of investment made pursuant to this section, the following information:

(i) The type of instruments in which customer funds have been invested;

(ii) The original cost of the instruments; and

(iii) The current market value of the instruments.

(c) *Money market mutual funds.* The following provisions will apply to the investment of customer funds in money market mutual funds (the fund).

(1) Generally, the fund must be an investment company that is registered under the Investment Company Act of 1940 with the Securities and Exchange Commission and that holds itself out to investors as a money market fund, in accordance with § 270.2a–7 of this title. A fund sponsor, however, may petition the Commission for an exemption from this requirement. The Commission may grant such an exemption provided that the fund can demonstrate that it will operate in a manner designed to preserve principal and to maintain liquidity. The application for exemption must describe how the fund's structure, operations and financial reporting are expected to differ from the requirements contained in § 270.2a–7 of this title and the risk-limiting provisions for direct investments contained in this section. The fund must also specify the information that the fund would make available to the Commission on an ongoing basis.

(2) The fund must be sponsored by a federally-regulated financial institution, a bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934, an investment adviser registered under the Investment Advisers Act of 1940, or a domestic branch of a foreign bank insured by the Federal Deposit Insurance Corporation, except for a fund exempted in accordance with paragraph (c)(1) of this section.

(3) A futures commission merchant or clearing organization shall maintain the confirmation relating to the purchase in its records in accordance with § 1.31 and note the ownership of fund shares (by book-entry or otherwise) in a custody account of the FCM or clearing organization in accordance with § 1.26(a). If the futures commission merchant or the clearing organization holds its shares of the fund with the fund's shareholder servicing agent, the sponsor of the fund and the fund itself are required to provide the acknowledgment letter required by § 1.26.

(4) The net asset value of the fund must be computed by 9 a.m. of the business day following each business day and made available to the futures commission merchant or clearing organization by that time.

(5) A fund must be able to redeem an interest by the business day following a redemption request by the futures commission merchant or clearing organization. Demonstration that this requirement has been met may include either an appropriate provision in the offering memorandum of the fund or a separate side agreement between the fund and a futures commission merchant or clearing organization.

(6) The agreement pursuant to which the futures commission merchant or clearing organization has acquired and is holding its interest in a fund must contain no provision that would prevent the pledging or transferring of shares.

(d) *Repurchase and reverse repurchase agreements.* A futures commission merchant or clearing organization may buy and sell the permitted investments listed in paragraphs (a)(1)(i) through (viii) of this section pursuant to agreements for resale or repurchase of the securities (agreements to repurchase or resell), provided the agreements to repurchase or resell conform to the following requirements:

(1) The securities are specifically identified by coupon rate, par amount, market value, maturity date, and CUSIP or ISIN number.

(2) Counterparties are limited to a bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934, a domestic branch of a foreign bank insured by the Federal Deposit Insurance Corporation, a securities broker or dealer, or a government securities broker or government securities dealer registered with the Securities and Exchange Commission or which has filed notice pursuant to section 15C(a) of the Government Securities Act of 1986.

(3) The transaction is executed in compliance with the concentration limit requirements applicable to the securities held in connection with the agreements to repurchase referred to in paragraphs (b)(4)(ii) and (iii) of this section.

(4) The transaction is made pursuant to a written agreement signed by the parties to the agreement, which is consistent with the conditions set forth in paragraphs (d)(1) through (d)(12) of this section and which states that the

parties thereto intend the transaction to be treated as a purchase and sale of securities.

(5) The term of the agreement is no more than one business day, or reversal of the transaction is possible on demand.

(6) The securities transferred under the agreement are held in a safekeeping account with a bank as referred to in paragraph (d)(2) of this section, a clearing organization, or the Depository Trust Company in an account that complies with the requirements of § 1.26.

(7) The futures commission merchant or the clearing organization may not use securities received under the agreement in another similar transaction and may not otherwise hypothecate or pledge such securities, except securities may be pledged on behalf of customers at another futures commission merchant or clearing organization. Substitution of securities is allowed, *provided, however,* that:

(i) The qualifying securities being substituted and original securities are specifically identified by date of substitution, market values substituted, coupon rates, par amounts, maturity dates and CUSIP or ISIN numbers;

(ii) Substitution is made on a ''delivery versus delivery'' basis; and

(iii) The market value of the substituted securities is at least equal to that of the original securities.

(8) The transfer of securities is made on a delivery versus payment basis in immediately available funds. The transfer is not recognized as accomplished until the funds and/or securities are actually received by the custodian of the futures commission merchant's or clearing organization's customer funds or securities purchased on behalf of customers. The transfer or credit of securities covered by the agreement to the futures commission merchant's or clearing organization's customer segregated custodial account is made simultaneously with the disbursement of funds from the futures commission merchant's or clearing organization's customer segregated cash account at the custodian bank. On the sale or resale of securities, the futures commission merchant's or clearing organization's customer segregated cash account at the custodian bank must receive same-day funds credited to such segregated account simultaneously with the delivery or transfer of securities from the customer segregated custodial account.

(9) A written confirmation to the futures commission merchant or clearing organization specifying the terms of the agreement and a safekeeping receipt are issued immediately upon entering into the transaction and a confirmation to the futures commission merchant or clearing organization is issued once the transaction is reversed.

(10) The transactions effecting the agreement are recorded in the record required to be maintained under § 1.27 of investments of customer funds, and the securities subject to such transactions are specifically identified in such record as described in paragraph (d)(1) of this section and further identified in such record as being subject to repurchase and reverse repurchase agreements.

(11) An actual transfer of securities by book entry is made consistent with Federal or State commercial law, as applicable. At all times, securities received subject to an agreement are reflected as ''customer property.''

(12) The agreement makes clear that, in the event of the bankruptcy of the futures commission merchant or clearing organization, any securities purchased with customer funds that are subject to an agreement may be immediately transferred. The agreement also makes clear that, in the event of a futures commission merchant or clearing organization bankruptcy, the counterparty has no right to compel liquidation of securities subject to an agreement or to make a priority claim for the difference between current market value of the securities and the price agreed upon for resale of the securities to the counterparty, if the former exceeds the latter.

(e) *Deposit of firm-owned securities into segregation.* A futures commission merchant shall not be prohibited from directly depositing unencumbered securities of the type specified in this section, which it owns for its own account, into a segregated safekeeping account or from transferring any such securities from a segregated account to its own account, up to the extent of its residual financial interest in customers' segregated funds; provided, however, that such investments, transfers of securities, and disposition of proceeds from the sale or maturity of such securities are recorded in the record of investments required to be maintained by § 1.27. All such securities may be segregated in safekeeping only with a bank, trust company, clearing organization, or other registered futures commission merchant. Furthermore, for purposes of §§ 1.25, 1.26, 1.27, 1.28 and 1.29, investments permitted by § 1.25 that are owned by the futures commission merchant and deposited into such a segregated account shall be considered customer funds until such investments are withdrawn from segregation.

7. Section 1.26 is revised to read as follows:

§ 1.26 Deposit of instruments purchased with customer funds.

(a) Each futures commission merchant who invests customer funds in instruments described in § 1.25 shall separately account for such instruments and segregate such instruments as belonging to such commodity or option customers. Such instruments, when deposited with a bank, trust company, clearing organization or another futures commission merchant, shall be deposited under an account name which clearly shows that they belong to commodity or option customers and are segregated as required by the Act and this part. Each futures commission merchant upon opening such an account shall obtain and retain in its files an acknowledgment from such bank, trust company, clearing organization or other futures commission merchant that it was informed that the instruments belong to commodity or option customers and are being held in accordance with the provisions of the Act and this part. *Provided, however,* that an acknowledgment need not be obtained from a clearing organization that has adopted and submitted to the Commission rules that provide for the segregation as customer funds, in accordance with all relevant provisions of the Act and the rules and orders promulgated thereunder, of all funds held on behalf of customers and all instruments purchased with customer funds. Such acknowledgment shall be retained in accordance with § 1.31. Such bank, trust company, clearing organization or other futures commission merchant shall allow inspection of such obligations at any reasonable time by representatives of the Commission.

(b) Each clearing organization which invests money belonging or accruing to commodity or option customers of its clearing members in instruments described in § 1.25 shall separately account for such instruments and segregate such instruments as belonging to such commodity or option customers. Such instruments, when deposited with a bank or trust company, shall be deposited under an account name which will clearly show that they belong to commodity or option customers and are segregated as required by the Act and this part. Each clearing organization upon opening such an account shall obtain and retain in its files a written acknowledgment

from such bank or trust company that it was informed that the instruments belong to commodity or option customers of clearing members and are being held in accordance with the provisions of the Act and this part. Such acknowledgment shall be retained in accordance with § 1.31. Such bank or trust company shall allow inspection of such instruments at any reasonable time by representatives of the Commission.

§ 1.27 [Amended]

8. Section 1.27 is amended by:

a. Revising the word ''obligations'' to read ''instruments'' each time it appears; and

b. Adding the phrase ''or ISIN'' following the word ''CUSIP'' each time it appears.

§§ 1.28 and 1.29 [Amended]

9. Sections 1.28 and 1.29 are amended by revising the word ''obligations'' to read ''instruments'' each time it appears.

10. Section 1.33 is amended by adding a new paragraph (g) to read as follows:

§ 1.33 Monthly and confirmation statements.

* * * * *

(g) *Electronic transmission of statements.* (1) The statements required by this section, and by § 1.46, may be furnished to any customer by means of electronic media if the customer so requests, *Provided, however,* that a futures commission merchant must, prior to the transmission of any statement by means of electronic media, disclose the electronic medium or source through which statements will be delivered, the duration, whether indefinite or not, of the period during which consent will be effective, any charges for such service, the information that will be delivered by such means, and that consent to electronic delivery may be revoked at any time.

(2) In the case of a customer who does not qualify as an ''institutional customer'' as defined in § 1.3(g), a futures commission merchant must obtain the customer's signed consent acknowledging disclosure of the information set forth in paragraph (g)(1) of this section prior to the transmission of any statement by means of electronic media.

(3) Any statement required to be furnished to a person other than a customer in accordance with paragraph (d) of this section may be furnished by electronic media.

(4) A futures commission merchant who furnishes statements to any customer by means of electronic media must retain a daily confirmation statement for such customer as of the end of the trading session, reflecting all transactions made during that session for the customer, in accordance with § 1.31.

* * * * *

11. Section 1.46 is amended as follows:

a. By revising paragraph (a), introductory text,

b. By removing and reserving paragraphs (d)(4) through (d)(7),

c. By removing paragraph (d)(9) and

d. By revising paragraph (e) to read as follows:

§ 1.46 Application and closing out of offsetting long and short positions.

(a) *Application of purchases and sales.* Except with respect to purchases or sales which are for omnibus accounts, or where the customer has instructed otherwise, any futures commission merchant who, on or subject to the rules of a contract market, recognized futures exchange or derivatives transaction facility:

* * * * *

(e) The statements required by paragraph (a) of this section may be furnished to the customer or the person described in § 1.33(d) by means of electronic transmission, in accordance with § 1.33(g).

* * * * *

12. Section 1.52 is amended by adding a new paragraph (m) to read as follows:

§ 1.52 Self-regulatory organization adoption and surveillance of minimum financial requirements.

* * * * *

(m) Nothing in this section shall apply to the activities of a derivatives transaction facility or the minimum adjusted net capital requirements it may require of persons operating thereon pursuant to § 1.17(a)(2)(iii).

* * * * *

13. Section 1.55 is amended by revising paragraphs (d) and (f) to read as follows:

§ 1.55 Distribution of ''Risk Disclosure Statement'' by futures commission merchants and introducing brokers.

* * * * *

(d) Any futures commission merchant, or in the case of an introduced account any introducing broker, may open a commodity futures account for a customer without obtaining the separate acknowledgments of disclosure and elections required by this section and by § 1.33(g), and by §§ 33.7, 155.3(b)(2), and 190.06 of this chapter, provided that:

(1) Prior to the opening of such account, the futures commission merchant or introducing broker obtains an acknowledgment from the customer, which may consist of a single signature at the end of the futures commission merchant's or introducing broker's customer account agreement, or on a separate page, of the disclosure statements and elections specified in this section and § 1.33(g), and in §§ 33.7, 155.3(b)(2), and 190.06 of this chapter, and which may include authorization for the transfer of funds from a segregated customer account to another account of such customer, as listed directly above the signature line, provided the customer has acknowledged by check or other indication next to a description of each specified disclosure statement or election that the customer has received and understood such disclosure statement or made such election;

(2) The acknowledgment referred to in paragraph (d)(1) of this section must be accompanied by and executed contemporaneously with delivery of the disclosures and elective provisions required by this section and § 1.33(g), and by §§ 33.7, 155.3(b)(2), and 190.06 of this chapter.

* * * * *

(f) A futures commission merchant or, in the case of an introduced account an introducing broker, may open a commodity futures account for an institutional customer without furnishing such institutional customer the disclosure statements or obtaining the acknowledgements required under paragraph (a) of this section, §§ 1.33(g) and 1.65(a)(3), and §§ 30.6(a), 33.7(a), 155.3(b)(2), and 190.10(c) of this chapter.

* * * * *

PART 3—REGISTRATION

14. The authority citation for Part 3 is revised to read as follows:

Authority: 5 U.S.C. 522, 522b; 7 U.S.C. 1a, 2, 4, 4a, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6k, 6m, 6n, 6o, 6p, 8, 9, 9a, 12, 12a, 13b, 13c, 16a, 18, 19, 21, 23.

15. Section 3.1 is amended by revising paragraphs (a)(1) and (a)(2) to read as follows:

§ 3.1 Definitions.

(a) * * *

(1) If the entity is organized as a sole proprietorship, the proprietor; if a partnership, any general partner; if a corporation, any director, the president, chief executive officer, chief operating officer, chief financial officer, and any person in charge of a principal business

unit, division or function subject to regulation by the Commission; if a limited liability company or limited liability partnership, any director, the president, chief executive officer, chief operating officer, chief financial officer, the manager, managing member or those members vested with the management authority for the entity, and any person in charge of a principal business unit, division or function subject to regulation by the Commission; and, in addition, any person occupying a similar status or performing similar functions, having the power, directly or indirectly, through agreement or otherwise, to exercise a controlling influence over the entity's activities that are subject to regulation by the Commission;

(2)(i) Any individual who directly or indirectly, through agreement, holding company, nominee, trust or otherwise, is the owner of ten percent or more of the outstanding shares of any class of stock, is entitled to vote or has the power to sell or direct the sale of ten percent or more of any class of voting securities, or is entitled to receive ten percent or more of the profits; or

(ii) Any person other than an individual that is the direct owner of ten percent or more of any class of securities; or

* * * * *

16. Section 3.10 is amended by revising paragraph (a)(1)(i), by redesignating paragraph (a)(2)(i) as paragraph (a)(2), by removing paragraph (a)(2)(ii), and by revising paragraph (d) to read as follows:

§ 3.10 Registration of futures commission merchants, introducing brokers, commodity trading advisors, commodity pool operators and leverage transaction merchants.

(a) *Application for registration.* (1)(i)(A) Except as provided in paragraph (a)(1)(i)(B) of this section, application for registration as a futures commission merchant, introducing broker, commodity trading advisor, commodity pool operator or leverage transaction merchant must be on Form 7–R, completed and filed with the National Futures Association in accordance with the instructions thereto.

(B) An applicant for registration as a futures commission merchant or introducing broker that will conduct transactions on or subject to the rules of a contract market, recognized futures exchange or derivatives transaction facility for institutional customers, and which is registered with the Securities and Exchange Commission as a securities broker or dealer, or is a bank or any other financial depository institution subject to regulation by the United States, may apply for registration by filing with the National Futures Association notice of its intention to undertake transactions on or subject to the rules of a contract market, recognized futures exchange, or derivatives transaction facility for institutional customers, together with a certification of registration and good standing with the appropriate authority or of authorization to engage in such transactions by said authority.

* * * * *

(d) *Annual filing.* Any person registered as a futures commission merchant, introducing broker, commodity trading advisor, commodity pool operator or leverage transaction merchant in accordance with paragraph (a)(1)(i)(A) of this section must file with the National Futures Association a Form 7–R, completed in accordance with the instructions thereto, annually on a date specified by the National Futures Association. The failure to file the Form 7–R within thirty days following such date shall be deemed to be a request for withdrawal from registration. On at least thirty days written notice, and following such action, if any, deemed to be necessary by the Commission or the National Futures Association, the National Futures Association may grant the request for withdrawal from registration.

* * * * *

17. Section 3.21 is amended by revising paragraph (c) introductory text to read as follows:

§ 3.21 Exemption from fingerprinting requirement in certain cases.

* * * * *

(c) *Outside directors.* Any futures commission merchant, introducing broker, commodity trading advisor, commodity pool operator or leverage transaction merchant that has a principal who is a director but is not also an officer or employee of the firm may, in lieu of submitting a fingerprint card in accordance with the provisions of §§ 3.10(a)(2)(i) and 3.31(a)(2), file a ''Notice Pursuant to Rule 3.21(c)'' with the National Futures Association. Such notice shall state, if true, that such outside director:

* * * * *

18. Section 3.31 is amended by redesignating paragraph (a) as paragraph (a)(1), and by adding new paragraph (a)(2) to read as follows:

§ 3.31 Deficiencies, inaccuracies, and changes, to be reported.

(a) * * *

(1) * * *

(2) Where the deficiency or inaccuracy is created by the addition of a new principal not listed on the registrant's application for registration (or amendment of such application prior to the granting of registration), each Form 3–R filed in accordance with the requirements of paragraph (a)(1) of this section must be accompanied by a Form 8–R, completed in accordance with the instructions thereto and executed by each natural person who is a principal of the registrant and who was not listed on the registrant's initial application for registration or any amendment thereto. The Form 8–R for each such principal must be accompanied by the fingerprints of that principal on a fingerprint card provided by the National Futures Association for that purpose, unless such principal is a director who qualifies for the exemption from the fingerprint requirement pursuant to § 3.21(c). The provisions of this paragraph do not apply to any principal who has a current Form 8–R on file with the Commission or the National Futures Association.

* * * * *

§ 3.32 [Removed]

19. Section 3.32 is removed.

§ 3.34 [Removed]

20. Section 3.34 is removed.

21. Appendix A to Part 3 is amended by adding to the end thereto the following:

Appendix A to Part 3—Interpretive Statement with Respect to Section 8A(2)(C) and (E) and Section 8A(3)(J) and (M) of the Commodity Exchange Act

* * * * *

The Commission has further addressed ''other good cause'' under Section 8a(3)(M) of the Act in issuing guidance letters on assessing the fitness of floor brokers, floor traders or applicants in either category:

[First guidance letter]

December 4, 1997.

Robert K. Wilmouth,

President, National Futures Association, 200 West Madison Street, Chicago, IL.

Re: Adverse Registration Actions with Respect to Floor Brokers, Floor Traders and Applicants for Registration in Either Category

Dear Mr. Wilmouth:

As you know, the Commission on June 26, 1997, approved for publication in the **Federal Register** a Notice and Order concerning adverse registration actions by the National Futures Association (''NFA'') with respect to registered floor brokers (''FBs''), registered floor traders (''FTs'') and applicants for registration in either category. 62 Fed. Reg. 36050 (July 3, 1997). The Notice and Order authorized NFA to grant or to maintain,

either with or without conditions or restrictions, FB or FT registration where NFA previously would have forwarded the case to the Commission for review of disciplinary history. The Commission has worked with its staff to determine which of the pending matters could efficiently be returned to NFA for handling, and such matters have been forwarded to NFA. The Commission will continue to accept or to act upon requests for exemption, and the Commission staff will consider requests for ''no-action'' opinions with respect to applicable registration requirements.

By this correspondence, the Commission is issuing guidance that provides NFA further direction on how it expects NFA to exercise its delegated power, based upon the experience of the Commission and the staff with the registration review process during the past three years. This guidance will help ensure that NFA exercises its delegated power in a manner consistent with Commission precedent.

In exercising its delegated authority, NFA, of course, needs to apply all of the provisions of Sections 8a(2) and (3) of the Commodity Exchange Act (''Act'').[1] In that regard, NFA should consider the matters in which the Commission has taken action in the past and endeavor to seek similar registration restrictions, conditions, suspensions, denials, or revocations under similar circumstances.

One of the areas in which NFA appears to have had the most uncertainty is with regard to previous self-regulatory organization (''SRO'') disciplinary actions. Commission Rule 1.63[2] provides clear guidelines for determining whether a person's history of ''disciplinary offenses'' should preclude service on SRO governing boards or committees.[3] In determining whether to grant or to maintain, either with or without conditions or restrictions, FB or FT registration, NFA should, as an initial matter, apply the Rule 1.63(a)(6) criteria to those registered FBs, registered FTs and applicants for registration in either category. However, NFA should be acting based upon any such offenses that occurred within the previous five years, rather than the three years provided for in Rule 1.63(c). NFA should consider disciplinary actions taken by an SRO as that term is defined in Section 3(a)(26) of the Securities Exchange Act of 1934 no differently from disciplinary actions taken by an SRO in the futures industry as defined in Rule 1.3(ee).[4] Application of the Rule 1.63 criteria, as modified, to these matters will aid NFA in making registration determinations that are reasonably consonant with Commission views.[5] NFA should focus on the nature of the underlying conduct rather than the sanction imposed by an SRO. Thus, if a disciplinary action would not come within the coverage of Rule 1.63 but for the imposition of a short suspension of trading privileges (such as for a matter involving fighting, use of profane language or minor recordkeeping violations), NFA could exercise discretion, as has the Commission, not to institute a statutory disqualification case. On the other hand, conduct that falls clearly within the terms of Rule 1.63, such as violations of rules involving potential harm to customers of the exchange, should not be exempt from review simply because the exchange imposed a relatively minor sanction.

The Commission has treated the registration process and the SRO disciplinary process as separate matters involving separate considerations. The fact that the Commission has not pursued its own enforcement case in a particular situation does not necessarily mean that the Commission considers the situation to be a minor matter for which no registration sanctions are appropriate. Further, the Commission believes that it and NFA, entities with industry-wide perspective and responsibilities, are the appropriate bodies, rather than any individual exchange, to decide issues relating to registration status, which can affect a person's ability to function in the industry well beyond the jurisdiction of a particular exchange. Thus, NFA's role is in no way related to review of exchange sanctions for particular conduct, but rather it is the entirely separate task of determining whether an FB's or FT's conduct should impact his or her registration.

NFA also should look to Commission precedent in selecting conditions or restrictions to be imposed, such as a dual trading ban where a person has been involved in disciplinary offenses involving customer abuse. Where conditions or restrictions are imposed, or agreed upon, NFA also should follow Commission precedent, under which such conditions or restrictions generally have been imposed for a two-year period.

The Commission has required sponsorship for conditioned FBs and FTs when their disciplinary offenses have involved noncompetitive trading and fraud irrespective of the level of sanctions imposed by an SRO. Indeed, but for a sponsorship requirement there would be no one routinely watching and responsible for the activities of these registrants. Absent sponsorship, such FBs and FTs would only be subject to routine Commission and exchange surveillance. The Commission's rules are premised upon the judgment that requiring FTs and FBs to have sponsors to ensure their compliance with conditions is both appropriate and useful. See Rule 3.60(b)(2)(i).

A question has arisen whether, if NFA is required to prove up the underlying facts of an SRO disciplinary action, the exchanges can provide information on exchange disciplinary proceedings directly to NFA. Although Section 8c(a)(2) of the Act states that an exchange shall not disclose the evidence for a disciplinary action except to the person disciplined and to the Commission, Section 8a(10) of the Act allows the Commission to authorize any person to perform any portion of the registration functions under the Act, notwithstanding any other provision of law. The effective discharge of the delegated registration function requires NFA to have access to the exchange evidence. Thus, the Commission believes that Section 8a(10) may reasonably be interpreted to allow the disclosure of information from exchange disciplinary proceedings directly to NFA despite the provisions of Section 8c(a)(2).

Nothing in the Notice and Order affects the Commission's authority to review the granting of a registration application by NFA in the performance of Commission registration functions, including review of the sufficiency of conditions or restrictions imposed by NFA, to review the determination by NFA not to take action to affect an existing registration, or to take its own action to address a statutory disqualification. Moreover, the Commission Order contemplates that to allow for appropriate Commission oversight of NFA's exercise of this delegated authority, NFA will provide for the Commission's review quarterly schedules of all applicants cleared for registration and all registrants whose registrations are maintained without adverse action by NFA's Registration, Compliance, Legal Committee despite potential statutory disqualifications.

The Commission will continue to monitor NFA activities through periodic rule enforcement reviews, and NFA remains subject to the present requirement that it

[1] 7 U.S.C. 12a(2) and (3) (1994). The letter is intended to supplement, not to supersede, other guidance provided in the past to NFA. In this regard, the NFA should continue to follow other guidance provided by the Commission or its staff.

[2] Commission rules referred to herein are found at 17 CFR Ch. I.

[3] Rule 1.63(c) provides that a person is ineligible from serving on an SRO's disciplinary committees, arbitration panels, oversight panels or governing board if, as provided in Rule 1.63(b), the person, inter alia: (1) within the past three years has been found by a final decision of an SRO, an administrative law judge, a court of competent jurisdiction or the Commission to have committed a disciplinary offense; or (2) within the past three years has entered into a settlement agreement in which any of the findings or, in the absence of such findings, any of the acts charged included a disciplinary offense.

Rule 1.63(a)(6) provides that a ''disciplinary offense'' includes: (i) any violation of the rules of an SRO except those rules related to (A) decorum or attire, (B) financial requirements, or (C) reporting or record-keeping unless resulting in fines aggregating more than $5,000 within any calendar year; (ii) any rule violation described in subparagraphs (A) through (C) above that involves fraud, deceit or conversion or results in a suspension or expulsion; (iii) any violation of the Act or the regulations promulgated thereunder; or (iv) any failure to exercise supervisory responsibility with respect to an act described in paragraphs (i) through (iii) above when such failure is itself a violation of either the rules of an SRO, the Act or the regulations promulgated thereunder.

[4] Thus, for example, a disciplinary action taken by the Chicago Board Options Exchange or the National Association of Securities Dealers, Inc. should be considered in a manner similar to a disciplinary action of the Chicago Board of Trade or NFA.

[5] In reviewing these matters, the NFA should bear in mind recent Commission precedent which allows for reliance on settled disciplinary proceedings in some circumstances. *See In the Matter of Michael J. Clark,* [1996–1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,032 (Apr. 22, 1997) (''other good cause'' under Section 8a(3)(M) of the Act exists based upon a pattern of exchange disciplinary actions resulting in significant sanctions for serious rule violations—whether settlements or adjudications), *aff'd sub nom., Clark v. Commodity Futures Trading Commission,* No. 97–4228 (2d Cir. June 4, 1999) (unpublished).

monitor compliance with the conditions and restrictions imposed on conditioned and restricted registrants.

Sincerely,

Jean A. Webb,

Secretary of the Commission.

[Second guidance letter]

April 13, 2000.

Robert K. Wilmouth,

President, National Futures Association, 200 West Madison Street, Chicago, IL.

Re: Use of Exchange Disciplinary Actions as *''Other Good Cause'' to Affect Floor Broker/Floor Trader Registration*

Dear Mr. Wilmouth:

I. Introduction and Background

In July 1997, the Commission issued a Notice and Order authorizing the National Futures Association (''NFA'') to grant or to maintain, either with or without conditions or restrictions, floor broker (''FB'') or floor trader (''FT'') registration where NFA previously would have forwarded the case to the Commission for review of disciplinary history.[1] By letter dated December 4, 1997 (''Guidance Letter''), the Commission provided further direction on how the Commission expected NFA to exercise its delegated power and to ensure that NFA exercised its delegated power in a manner consistent with Commission precedent.

The Commission has determined to revise the Guidance Letter. Specifically, the Commission is revising the portion of the Guidance Letter that addresses the use of exchange disciplinary actions as ''other good cause'' to affect FB and FT registrations. The Commission has made this determination following its own reconsideration of the issue and at the urging of industry members.[2]

The Guidance Letter pointed out that, in exercising its delegated authority, NFA must apply all of the provisions of Sections 8a(2) and (3) of the Commodity Exchange Act (''Act'').[3] In particular, Section 8a(3)(M) of the Act authorizes the Commission to refuse to register or to register conditionally any person if it is found, after opportunity for hearing, that there is other good cause for statutory disqualification from registration beyond the specifically listed grounds in Sections 8a(2) and 8a(3) of the Act. The Commission held in *In the Matter of Clark* that statutory disqualification under the ''other good cause'' provision of Section 8a(3)(M) may arise on the basis of, among other things, a pattern of exchange disciplinary actions alleging serious rule violations that result in significant sanctions, and that it is immaterial whether the sanctions imposed resulted from a fully-adjudicated disciplinary action or an action that was taken following a settlement.[4]

The Guidance Letter recommended the application of the provisions of Commission Rule 1.63[5] as criteria to aid in assessing the impact of an FB or FT applicant's or registrant's previous disciplinary history on the person's fitness to be registered, with the exception that NFA should be acting based on disciplinary history from the previous five years, rather than the three years provided for in Rule 1.63.[6] The Guidance Letter also noted that NFA should consider disciplinary actions taken not only by futures industry SROs but also those taken by SROs as defined in Section 3(a)(26) of the Securities Exchange Act of 1934 (''1934 Act''), including settled disciplinary actions.

II. Revised Guidance

As stated above, the Commission has determined to revise the Guidance Letter. From this point forward, NFA should cease using Rule 1.63 as the basis to evaluate the impact of an FB or FT applicant's or registrant's disciplinary history on his or her fitness to be registered. Instead, as *Clark* stated, when reviewing disciplinary history to assess the fitness to be registered of an FB, FT, or applicant in either category, a pattern of exchange disciplinary actions alleging serious rule violations that result in significant sanctions will trigger the ''other good cause'' provision of Section 8a(3)(M). The ''pattern'' should consist of at least two final exchange disciplinary actions, whether settled or adjudicated.

NFA also should consider initiating proceedings to affect the registration of the FB or FT, even if there is only a single exchange action against the FB or FT, if the exchange action was based on allegations of particularly egregious misconduct or involved numerous instances of misconduct occurring over a long period of time. If, however, a proceeding is initiated based on a single exchange action that was disposed of by settlement, NFA may have to prove up the underlying misconduct. Furthermore, traditional principles of collateral estoppel apply to adjudicated actions, whether they are being considered individually or as part of a pattern.[7]

As provided by the Guidance Letter, ''exchange disciplinary actions'' would continue to include disciplinary actions taken by both futures industry SROs and SROs as defined in Section 3(a)(26) of the 1934 Exchange Act. Furthermore, NFA should review an applicant's or registrant's disciplinary history for the past five years.[8] At least one of the actions forming the pattern, however, must have become final after *Clark* was decided by the Commission on April 22, 1997. Finally, ''serious rule violations'' consist of, or are substantially related to, charges of fraud, customer abuse, other illicit trading practices, or the obstruction of an exchange investigation.

Congress, the courts and the Commission have indicated the importance of considering an applicant's history of exchange disciplinary actions in assessing that person's fitness to register.[9] Furthermore, NFA's review of exchange disciplinary actions within the context of the registration process should not simply mirror the disciplinary actions undertaken by the exchanges. The two processes are separate matters that involve separate considerations. As part of their ongoing self-regulatory obligations, exchanges must take disciplinary action[10] and such disciplinary matters necessarily focus on the specific misconduct that forms the allegation. In a statutory disqualification action, however, NFA must determine whether the disciplinary history of an FB, FT or applicant over the preceding five years should impact his or her registration. Additionally, NFA possesses industry-wide perspective and responsibilities. As such, NFA, rather than an individual exchange, should decide registration status issues, since those issues affect an individual's status

[1] Registration Actions by National Futures Association With Respect to Floor Brokers, Floor Traders and Applicants for Registration in Either Category, 62 FR 36050 (July 3, 1997).

[2] *See* letters submitted by James Bowe, former president of the New York Board of Trade (''NYBOT''), dated October 13, 1999, Christopher Bowen, general counsel of the New York Mercantile Exchange (''NYMEX''), dated October 18, 1999, and the Joint Compliance Committee (''JCC''), dated February 2, 2000. The JCC consists of senior compliance officials from all domestic futures exchanges and the NFA (*i.e.,* the domestic self-regulatory organizations (''SROs'')). In addition, staff from the Contract Markets Section of the Commission's Division of Trading and Markets attend the JCC meetings as observers. The JCC was established to aid in the development of improved compliance systems through joint efforts and information-sharing among the SROs. Commission staff have also discussed this issue with SRO staff.

[3] 7 U.S.C. 12a(2) and (3) (1994).

[4] *In the Matter of Clark,* [1996–1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,032 (Apr. 22, 1997), *aff'd sub nom., Clark* v. *Commodity Futures Trading Commission,* No. 97–4228 (2d Cir. June 4, 1999) (unpublished).

[5] Commission rules referred to in this letter are found at 17 CFR Ch. 1.

[6] Rule 1.63 provides, among other things, that a person is ineligible from serving on SRO disciplinary committees, arbitration panels, oversight panels or governing boards if that person, *inter alia,* entered into a settlement agreement within the past three years in which any of the findings or, in the absence of such findings, any of the acts charged included a disciplinary offense.

Rule 1.63(a)(6) defines a ''disciplinary offense'' to include:

(i) any violation of the rules of an SRO except those rules related to (A) decorum or attire, (B) financial requirements, or (C) reporting or record-keeping unless resulting in fines aggregating more than $5,000 within any calendar year; (ii) any rule violation described in subparagraphs (A) through (C) above that involves fraud, deceit or conversion or results in a suspension or expulsion; (iii) any violation of the Act or the regulations promulgated thereunder; or (iv) any failure to exercise supervisory responsibility with respect to an act described in paragraphs (i) through (iii) above when such failure is itself a violation of either the rules of an SRO, the Act or the regulations promulgated thereunder.

[7] *Clark* at 44,929.

[8] The Commission generally looked at a five-year period of disciplinary history. On occasion, however, the Commission examined a longer period of an applicant's or registrant's disciplinary history. For example, the Commission revoked the registration of one FB on the basis of exchange disciplinary cases that extended back six years, *see Clark,* 2 Comm. Fut. L. Rep. (CCH) ¶ 27,032, and denied an application for registration as an FT on the basis of exchange disciplinary cases that extended back seven years, *see In the Matter of Castellano,* [1987–1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,360 (Nov. 23, 1988), *summarily aff'd* (May 29, 1990), *reh. denied* [1990–1992 Transfer Binder] Comm. Fut. L. Rep. ¶ 24,870 (June 26, 1990), *aff'd sub nom. Castellano* v. *CFTC,* Docket No. 90–2298 (7th Cir. Nov. 20, 1991).

[9] Letter dated July 14, 1995, from Mary L. Schapiro to R. Patrick Thompson, President, New York Mercantile Exchange (unpublished). *See also Castellano, supra* note 8.

[10] *See* Rule 1.51(a)(7).

within the industry as a whole, well beyond the jurisdiction of a particular exchange.

The Commission also wants to clarify to the fullest extent possible that its power to delegate the authority to deny or condition the registration of an FB, FT, or an applicant for registration in either category permits exchanges to disclose to NFA all evidence underlying exchange disciplinary actions, notwithstanding the language of Section 8c(a)(2) of the Act.[11] The Commission's power to delegate stems from Section 8a(10) of the Act, which permits delegation of registration functions, including statutory disqualification actions, to any person in accordance with rules adopted by such person and submitted to the Commission for approval or for review under Section 17(j) of the Act, ''notwithstanding any other provision of law.'' Certainly, Section 8c(a)(2) qualifies as ''any other provision of law.'' Furthermore, the effective discharge of the delegated function requires NFA to have access to the exchange evidence. Thus, the exercise of the delegated authority pursuant to Section 8a(10) permits the exchanges to disclose all evidence underlying disciplinary actions to NFA.[12]

This letter supersedes the Guidance Letter to the extent discussed above. In all other aspects, the Guidance Letter and other guidance provided by the Commission or its staff remain in effect. Therefore, NFA should continue to follow Commission precedent when selecting conditions or restrictions to be imposed. For example, NFA should impose a dual trading ban where customer abuse is involved and any conditions or restrictions imposed should be for a two-year period. Furthermore, NFA should require sponsorship for conditioned FBs or FTs when their disciplinary offenses involve noncompetitive trading and fraud.

Nothing in the Notice and Order or this letter affects the Commission's authority to review the granting of a registration application by NFA in the performance of Commission registration functions, including review of the sufficiency of conditions or restrictions imposed by NFA, to review the determination by NFA not to take action to affect an existing registration, or to take its own action to address a statutory disqualification. Moreover, the Commission Order contemplates that to allow for appropriate Commission oversight of NFA's exercise of this delegated authority, NFA will provide for the Commission's review quarterly schedules of all applicants cleared for registration and all registrants whose registrations are maintained without adverse action by NFA's Registration, Compliance, Legal Committee despite potential statutory disqualifications.

The Commission will continue to monitor NFA activities through periodic rule enforcement reviews, and NFA remains subject to the present requirement that it monitor compliance with the conditions and restrictions imposed on conditioned and restricted registrants.

Sincerely,

Jean A. Webb,
Secretary of the Commission.

22. Part 3 is amended by adding Appendix B to read as follows:

Appendix B to Part 3—Statement of Acceptable Practices with Respect to Ethics Training

(a) The provisions of section 4p(b) of the Act (7 U.S.C. 6p(b) (1994)) set forth requirements regarding training of registrants as to their responsibilities to the public. This section requires the Commission to issue regulations requiring new registrants to attend ethics training sessions within six months of registration, and all registrants to attend such training on a periodic basis. Consistent with the will of Congress, the Commission believes that a Core Principle for all persons intermediating transactions in recognized multilateral trade execution facilities is fitness. The awareness and maintenance of professional ethical standards are essential elements of a registrant's fitness. Further, the use of ethics training programs is relevant to a registrant's maintenance of adequate supervision, itself a Core Principle, and a requirement under Rule 166.3.

(b)(1) The Commission recognizes that technology has provided new, faster means of sharing and distributing information. In view of the foregoing, the Commission has chosen to allow registrants to develop their own ethics training programs. Nevertheless, futures industry professionals may want guidance as to the role of ethics training. Registrants may wish to consider what ethics training should be retained, its format, and how it might best be implemented. Therefore, the Commission finds it appropriate to issue this Statement of Acceptable Practices regarding appropriate training for registrants, as interpretative guidance for intermediaries on fitness and supervision. Commission registrants may look to this Statement of Acceptable Practices as a ''safe harbor'' concerning acceptable procedures in this area.

(2) The Commission believes that section 4p(b) of the Act reflects an intent by Congress that industry professionals be aware, and remain abreast, of their continuing obligations to the public under the Act and the regulations thereunder. The text of the Act provides guidance as to the nature of these responsibilities. As expressed in section 4p(b) of the Act, personnel in the industry have an obligation to the public to observe the Act, the rules of the Commission, the rules of any appropriate self-regulatory organizations or contract markets (which would also include recognized futures exchanges and recognized derivatives transactions facilities), or other applicable federal or state laws or regulations. Further, section 4p(b) acknowledges that registrants have an obligation to the public to observe ''just and equitable principles of trade.''

(3) Additionally, section 4p(b) reflects Congress' intent that registrants and their personnel retain an up-to-date knowledge of these requirements. The Act requires that registrants receive training on a periodic basis. Thus, it is the intent of Congress that Commission registrants remain current with regard to the ethical ramifications of new technology, commercial practices, regulations, or other changes.

(c) The Commission believes that training should be focused to some extent on a person's registration category, although there will obviously be certain principles and issues common to all registrants and certain general subjects that should be taught. Topics to be addressed include:

(1) An explanation of the applicable laws and regulations, and the rules of self-regulatory organizations or contract markets, recognized futures exchanges and derivatives transaction facilities;

(2) The registrant's obligation to the public to observe just and equitable principles of trade;

(3) How to act honestly and fairly and with due skill, care and diligence in the best interests of customers and the integrity of the market;

(4) How to establish effective supervisory systems and internal controls;

(5) Obtaining and assessing the financial situation and investment experience of customers;

(6) Disclosure of material information to customers; and

(7) Avoidance, proper disclosure and handling of conflicts of interest.

(d) An acceptable ethics training program would apply to all of a firm's associated persons and its principals to the extent they are required to register as associated persons. Additionally, personnel of firms that rely on their registration with other regulators, such as the Securities and Exchange Commission, should be provided with ethics training to the extent the Act and the Commission's regulations apply to their business.

(e) As to the providers of such training, the Commission believes that classes sponsored by independent persons, firms, or industry associations would be acceptable. It would also be permissible to conduct in-house training programs. Further, registrants should ascertain the credentials of any ethics training providers they retain. Thus, persons who provide ethics training should be required to provide proof of satisfactory completion of the proficiency testing requirements applicable to the registrant and evidence of three years of relevant industry or pedagogical experience in the field. This industry experience might include the practice of law in the fields of futures or securities, or employment as a trader or risk manager at a brokerage or end-user firm. Likewise, the Commission believes that registrants should employ as ethics training providers only those persons they reasonably believe in good faith are not subject to any investigations or to bars to registration or to

[11] Section 8c(a)(2) states, in relevant part, that ''[A]n exchange * * * shall not disclose the evidence therefor, except to the person who is suspended, expelled, disciplined, or denied access, and to the Commission.''

[12] Of course, the Commission could request records from the exchange and forward them to NFA. The Commission believes that this is an unnecessary administrative process and that NFA should obtain the records it needs to carry out the delegated function of conducting disciplinary history reviews directly from the exchanges. In this context and pursuant to Commission orders authorizing NFA to institute adverse registration actions, NFA should be viewed as standing in the shoes of the Commission.

service on a self-regulatory organization governing board or disciplinary panel.

(f)(1) With regard to the frequency and duration of ethics training, it is permissible for a firm to require training on whatever periodic basis and duration the registrant (and relevant self-regulatory organizations) deems appropriate. It may even be appropriate not to require any such specific requirements as, for example, where ethics training could be termed ongoing. For instance, a small entity, sole proprietorship, or even a small section in an otherwise large firm, might satisfy its obligation to remain current with regard to ethics obligations by distribution of periodicals, legal cases, or advisories. Use of the latest information technology, such as Internet websites, can be useful in this regard. In such a context, there would be no structured classes, but the goal should be a continuous awareness of changing industry standards. A corporate culture to maintain high ethical standards should be established on a continuing basis.

(2) On the other hand, larger firms which transact business with a larger segment of the public may wish to implement a training program that requires periodic classwork. In such a situation, the Commission believes it appropriate for registrants to maintain such records as evidence of attendance and of the materials used for training. In the case of a floor broker or floor trader, the applicable contract market, recognized futures exchange or derivatives transaction facility should maintain such evidence on behalf of its member. This evidence of ethics training could be offered to demonstrate fitness and overall compliance during audits by self-regulatory organizations, and during reviews of contract market, recognized futures exchange or derivatives transaction facility operations.

(g) The methodology of such training may also be flexible. Recent innovations in information technology have made possible new, fast, and cost-efficient ways for registrants to maintain their awareness of events and changes in the commodity interest markets. In this regard, the Commission recognizes that the needs of a firm will vary according to its size, personnel, and activities. No format of classes will be required. Rather, such training could be in the form of formal class lectures, video presentation, Internet transmission, or by simple distribution of written materials. These options should provide sufficiently flexible means for adherence to Congressional intent in this area.

(h) Finally, it should be noted that self-regulatory organizations and industry associations will have a significant role in this area. Such organizations may have separate ethics and proficiency standards, including ethics training and testing programs, for their own members.

PART 4—COMMODITY POOL OPERATORS AND COMMODITY TRADING ADVISORS

23. The authority citation for Part 4 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 4, 6b, 6c, 6l, 6m, 6n, 6o, 12a, and 23.

24. Section 4.10 is amended by revising paragraph (e)(1) to read as follows:

§ 4.10 Definitions.

* * * * *

(e)(1) *Principal,* when referring to a person that is a principal of a particular entity, shall have the same meaning as the term ''principal'' under § 3.1(a) of this chapter.

* * * * *

25. Section 4.24 is amended by revising paragraphs (f)(1)(v) and (h)(2) to read as follows:

§ 4.24 General disclosures required.

* * * * *

(f) * * *

(1) * * *

(v) Each principal of the persons referred to in this paragraph (b)(1) who participates in making trading or operational decisions for the pool or who supervises persons so engaged.

* * * * *

(h) * * *

(2) A description of the trading and investment programs and policies that will be followed by the offered pool, including the method chosen by the pool operator concerning how futures commission merchants carrying the pool's accounts shall treat offsetting positions pursuant to § 1.46 of this chapter, if the method is other than to close out all offsetting positions or to close out offsetting positions on other than a first-in, first-out basis, and any material restrictions or limitations on trading required by the pool's organizational documents or otherwise. This description must include, if applicable, an explanation of the systems used to select commodity trading advisors, investee pools and types of investment activity to which pool assets will be committed;

* * * * *

26. Section 4.32 is added to read as follows:

§ 4.32 Trading on a derivatives transaction facility for non-institutional customers.

(a) A registered commodity trading advisor may enter trades on or subject to the rules of a derivatives transaction facility on behalf of a client who does not qualify as an ''institutional customer'' as defined in § 1.3(g) of this chapter, provided that the trading advisor:

(1) Directs the client's commodity interest account;

(2) Directs accounts containing total assets of not less than $25,000,000 at the time the trade is entered; and

(3) Discloses to the client that the trading advisor may enter trades on or subject to the rules of a derivatives transaction facility on the client's behalf.

(b) The commodity interest account of a client described in paragraph (a) of this section must be carried by a registered futures commission merchant.

27. Section 4.34 is amended by revising paragraphs (f)(1)(ii) and (h) to read as follows:

§ 4.34 General disclosures required.

* * * * *

(f) * * *

(1) * * *

(ii) Each principal of the trading advisor who participates in making trading or operational decisions for the trading advisor or supervises persons so engaged.

* * * * *

(h) *Trading program.* A description of the trading program, which must include the method chosen by the commodity trading advisor concerning how futures commission merchants carrying accounts it manages shall treat offsetting positions pursuant to § 1.46 of this chapter, if the method is other than to close out all offsetting positions or to close out offsetting positions on other than a first-in, first-out basis, and the types of commodity interests and other interests the commodity trading advisor intends to trade, with a description of any restrictions or limitations on such trading established by the trading advisor or otherwise.

PART 140—ORGANIZATION, FUNCTIONS AND PROCEDURES OF THE COMMISSION

28. The authority citation for Part 140 continues to read as follows:

Authority: 7 U.S.C. 4a, 12a.

29. Section 140.91 is amended by adding a new paragraph (a)(7) to read as follows:

§ 140.91 Delegation of authority to the Director of the Division of Trading and Markets.

(a) * * *

(7) All functions reserved to the Commission in § 1.25 of this chapter.

* * * * *

PART 155—TRADING STANDARDS

30. The authority citation for Part 155 continues to read as follows:

Authority: 7 U.S.C. 6b, 6c, 6g, 6j and 12a unless otherwise noted.

§§ 155.2, 155.3, 155.4 and 155.5 [Amended]

31. Sections 155.2, 155.3, 155.4 and 155.5 are amended by adding the words ''or recognized futures exchange'' after the words ''contract market'' each time they appear.

32. Section 155.6 is added to read as follows:

§ 155.6 Trading standards for the transaction of business on derivatives transaction facilities.

(a) A futures commission merchant, or affiliated person thereof, transacting business on behalf of a customer who does not qualify as an ''institutional customer'' as defined in § 1.3(g) of this chapter on a derivatives transaction facility shall comply with the provisions of § 155.3.

(b) No futures commission merchant, introducing broker or affiliated person thereof shall misuse knowledge of any institutional customer's order for execution on a derivatives transaction facility.

PART 166—CUSTOMER PROTECTION RULES

33. The authority citation for Part 166 is amended to read as follows:

Authority: 7 U.S.C. 1a, 2, 4, 6b, 6c, 6d, 6g, 6h, 6k, 6l, 6o, 7a, 12a, 21 and 23, unless otherwise noted.

34. Section 166.5 is added to read as follows:

§ 166.5 Dispute settlement procedures.

(a) *Definitions.* (1) The term *claim or grievance* as used in this section shall mean any dispute that:

(i) Arises out of any transaction executed on or subject to the rules of a contract market, a recognized futures exchange or a derivatives transaction facility,

(ii) Is executed or effected through a member of such facility, a participant transacting on or through such facility or an employee of such facility, and

(iii) Does not require for adjudication the presence of essential witnesses or third parties over whom the facility does not have jurisdiction and who are not otherwise available.

(iv) The term claim or grievance does not include disputes arising from cash market transactions that are not a part of or directly connected with any transaction for the purchase or sale of any commodity for future delivery or commodity option.

(2) The term *customer* as used in this section includes an option customer (as defined in § 1.3(jj) of this chapter) and any person for or on behalf of whom a member of a contract market, a recognized futures exchange or a derivatives transaction facility or a participant transacting on or through such market, exchange or facility effects a transaction on or through such market, exchange or facility, except another member of or participant in such market, exchange or facility. *Provided, however,* a person who is an ''institutional customer'' as defined in § 1.3(g) of this chapter shall not be deemed to be a customer within the meaning of this section.

(3) The term *Commission registrant* as used in this section means a person registered under the Act as a futures commission merchant, introducing broker, floor broker, commodity pool operator, commodity trading advisor, or associated person.

(b) *Voluntariness.* The use by customers of dispute settlement procedures shall be voluntary as provided in paragraph (c) of this section.

(c) *Pre-dispute arbitration agreements.* No Commission registrant shall enter into any agreement or understanding with a customer in which the customer agrees, prior to the time a claim or grievance arises, to submit such claim or grievance to any settlement procedure except as follows:

(1) Signing the agreement must not be made a condition for the customer to utilize the services offered by the Commission registrant.

(2) If the agreement is contained as a clause or clauses of a broader agreement, the customer must separately endorse the clause or clauses containing the cautionary language and provisions specified in this section. A futures commission merchant or introducing broker may obtain such endorsement as provided in § 1.55(d) of this chapter for the following classes of customers only:

(i) A plan defined as a government plan or church plan in section 3(32) or section 3(33) of title I of the Employee Retirement Income Security Act of 1974, or a foreign person performing a similar role or function subject as such to comparable foreign regulation; and

(ii) A person who is a ''qualified eligible person'' as defined in § 4.7 of this chapter.

(3) The agreement may not require the customer to waive the right to seek reparations under section 14 of the Act and part 12 of this chapter. Accordingly, the customer must be advised in writing that he or she may seek reparations under section 14 of the Act by an election made within 45 days after the Commission registrant notifies the customer that arbitration will be demanded under the agreement. This notice must be given at the time when the Commission registrant notifies the customer of an intention to arbitrate. The customer must also be advised that if he or she seeks reparations under section 14 of the Act and the Commission declines to institute reparation proceedings, the claim or grievance will be subject to the pre-existing arbitration agreement and must also be advised that aspects of the claim or grievance that are not subject to the reparations procedure (*i.e.,* do not constitute a violation of the Act or rules thereunder) may be required to be submitted to the arbitration or other dispute settlement procedure set forth in the pre-existing arbitration agreement.

(4) The agreement must advise the customer that, at such time as he or she may notify the Commission registrant that he or she intends to submit a claim to arbitration, or at such time as such person notifies the customer of its intent to submit a claim to arbitration, the customer will have the opportunity to elect a qualified forum for conducting the proceeding.

(5) *Election of forum.* (i) Within ten business days after receipt of notice from the customer that he or she intends to submit a claim to arbitration, or at the time a Commission registrant notifies the customer of its intent to submit a claim to arbitration, the Commission registrant must provide the customer with a list of organizations whose procedures meet Acceptable Practices established by the Commission for customer dispute resolution, together with a copy of the rules of each forum listed. The list must include:

(A) The contract market, recognized futures exchange or derivatives transaction facility, if available, upon which the transaction giving rise to the dispute was executed or could have been executed;

(B) A registered futures association; and

(C) At least one other organization that will provide the customer with the opportunity to select the location of the arbitration proceeding from among several major cities in diverse geographic regions and that will provide the customer with the choice of a panel or other decision-maker composed of at least one or more persons, of which at least a majority are not members or associated with a member of the contract market, recognized futures exchange or derivatives transaction facility or employee thereof, and that are not otherwise associated with the contract market, recognized futures exchange or derivatives transaction facility (mixed panel): *Provided,*

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.

39.1 Scope and definitions.
39.2 Permitted clearing.
39.3 Conditions for recognition as a recognized clearing organization.
39.4 Procedures for recognition.
39.5 Enforceability.
39.6 Fraud in connection with the clearing of transactions by a recognized clearing organization.
Appendix A to Part 39—Application Guidance

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

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

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] 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

nine trade associations,[5] three future exchanges,[6] two brokerage firms,[7] a coalition of commercial and investment banks,[8] four law firms,[9] four representatives of the energy services community,[10] an agricultural firm [11] and others.[12]

The majority of commenters strongly supported the Commission's proposed amendments and expressed the view that the amendments, among other things, would increase legal certainty for the OTC market. Two commenters took the opposite view, expressing jurisdictional concerns. The commenters also raised a number of technical issues concerning the operation of the exemption, the definition of ''eligible participant'' and other matters. The comments are addressed in the final rules section below.

III. The Final Rules

A. The Exemption

Except for certain technical changes, the Commission is adopting the proposed rules expanding and clarifying the operation of the swaps exemption as final rules. As noted above, the majority of commenters strongly supported the amendments, expressing the view that they will increase legal certainty for the OTC market and reduce systemic risk. See, *e.g.*, CL 24–6; CL 24–8; CL 24–25; CL 24–29; CL 24–30; CL 24–31; CL 24–34; CL 24–36. The International Swaps and Derivatives Association (ISDA) views the proposed amendments as necessary to ensuring that new and evolving risk management tools will enjoy legal certainty comparable to that which has been available to transactions covered by the Commission's swaps exemption since 1993. CL 24–8 at 2. See also CL 24–6 at 3; CL 24–29 at 3–4. ISDA specifically commented that: The proposed expansion of the exemption to cover all bilateral agreements would ''enable market participants to focus on legal and economic substance rather than labels'' (CL 24–8 at 3); that the elimination of the requirement that exempt transactions not be standardized or fungible would ''eliminate a potential source of uncertainty with respect to the scope of the exemption'' (*id.*); that the authorization of clearing would ''eliminate the 'Hobson's Choice' that now exists between legal certainty and the use of clearing to reduce systemic risk'' (*id.*); and that the nonrepudiation provisions would deal directly with the ''main source of legal risk under the CEA'' (*id.* at 5). As ISDA noted, the substantial growth of the OTC swaps market since the Commission first promulgated part 35 in 1993:

> did not occur in a vacuum. It was fostered by this Commission in an earlier regulatory initiative commencing with the release of the Swaps Policy Statement in 1989 and continuing with the promulgation of the Swaps Exemption * * * and the Hybrids Exemption * * * These latter actions were of course entirely consistent with the intent of Congress, as reflected in the enactment of the Futures Trading Practices Act of 1992. * * * The pivotal role that OTC derivatives transaction [sic] now play in our economy is an outgrowth of these earlier policies of the Commission and the continuing expressions of support for those policies by Congress. ISDA believes that the proposed regulatory initiative now under consideration can and should be viewed as a vital and positive step in carrying out the Commission's long-standing policy with respect to OTC derivatives.
>
> ISDA believes that * * * the proposed regulatory initiative is an important change for the better. We applaud the sensitivity of both the Commission and its professional staff to the need to avoid structuring the proposals in ways that could result in legal *un*certainty, and we believe that the proposals *will not* have this effect. We likewise applaud the decision of the Commission to propose specific actions intended to increase, within the parameters of the CEA, legal certainty and we believe the proposals *will* have this effect. * * *

(CL 24–8 at 2; emphasis in original).

One commenter, however, the Regulatory Studies Program of the Mercatus Center (Mercatus), expressed the view that, by expanding the category of products to which the exemption applies, the Commission may exacerbate rather than reduce legal uncertainty. CL 24–21 at 4–5. Mercatus is concerned about the ''implications'' of the broad definitions used, commenting that, if adopted as proposed, the Commission could attempt to exercise its antifraud authority over contracts, agreements and transactions as to which it has no jurisdiction. *Id.* Mercatus suggests that the Commission instead limit the scope of part 35 to instruments over which the Act vests the Commission with jurisdiction, such as ''contracts of sale of a commodity for future delivery.'' *Id.* at 9.[13]

These amendments, however, do not expand the Commission's jurisdiction. To the contrary, the substance of part 35's scope provision remains unchanged from the current part 35 exemption.[14] Furthermore, the Commission's antifraud authority in rule 35.3, as proposed and as being adopted herein, is limited to ''*transactions and persons otherwise subject to those [antifraud] provisions*'' (emphasis added). Thus, the antifraud provisions will continue to apply only to those transactions already covered by them. The Commission's approach is consistent with how Congress intended the Commission to exercise its exemptive authority.[15]

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rulemaking on multilateral transaction execution facilities, parts 36–38, are contained in file No. 21, on the notice of proposed rulemaking on intermediaries in file No. 22, on the notice of proposed rulemaking on clearing organizations in file No. 23 and on the notice of proposed rulemaking on the part 35 exemption in file No. 24. These letters are available through the Commission's internet web site, http://www.cftc.gov.

[5] The associations that filed comment letters are the Managed Funds Association, the International Swaps and Derivatives Association, Inc., the National Grain and Feed Association, the Futures Industry Association, the Commodity Floor Brokers & Traders Association, the Silver Users Association, the Weather Risk Management Association, the Association for Investment Management and Research, Advocacy Advisory Committee, Derivatives Subcommittee, and the Securities Industry Association, OTC Derivatives Products Committee.

[6] The futures exchanges that filed comment letters are the Chicago Board of Trade, the New York Mercantile Exchange and the Chicago Mercantile Exchange.

[7] The brokerage firms that filed comment letters are Merrill Lynch & Co. Inc. and J.P. Morgan Securities Inc.

[8] The coalition of commercial and investment banks (the Coalition) consists of the following financial institutions: The Chase Manhattan Bank, Citigroup Inc., Credit Suisse First Boston Inc., Goldman Sachs & Co., Merrill Lynch & Co., Inc. and Morgan Stanley Dean Witter & Co.

[9] The law firms that filed comment letters are Covington & Burling, McDermott, Will & Emery, on behalf of Virginia Electric & Power Company, Vinson and Elkins, and Gardner, Carter and Douglas.

[10] The representatives of the energy services community that filed comment letters are Williams Energy Marketing and Trading Company, the California Power Exchange, Oxy Energy Services, Inc. and Petrocosm Corporation.

[11] The agricultural firm that filed a comment letter is Cargill.

[12] The others filing comment letters are the National Futures Association, the Financial Markets Lawyers Group, the Federal Reserve Bank of Chicago, the U.S. Department of the Treasury, the Regulatory Studies Program of the Mercatus Center, Reuters Group PLC, and The EBS Partnership.

[13] J.P. Morgan Securities Inc. (J.P. Morgan) raises jurisdictional issues similar to those raised by Mercatus, while specifically focusing on the Commission's proposed rules concerning exempt multilateral transaction execution facilities and recognized clearing organizations. CL 24–19 at 2–5. The Commission is responding to those comments more thoroughly in its companion releases on those matters.

[14] Commission rule 35.1(a) provides that the provisions of the exemption apply to any transaction ''*which may be subject to the Act*'' (emphasis added). The final rules amend this scope provision to incorporate a technical amendment which substitutes the phrase ''any contract, agreement or transaction'' for ''any swap agreement.'' This change merely conforms the formal statement of scope in rule 35.1(a) to the substantive provisions of the rule.

[15] When it adopted section 4(c) in 1992, the Conferees of the Congress stated:

> The Conferees do not intend that the exercise of exemptive authority by the Commission [under section 4(c)] would require any determination

Continued

Moreover, the contract nonrepudiation provision that the Commission is adopting today further removes any potential legal uncertainty. As one commenter, McDermott, Will & Emery, on behalf of Virginia Electric & Power Company, noted, this provision ''would prevent economically disappointed counterparties from bringing a private cause of action seeking to void the contract on the theory that it is illegal.'' CL 24–25 at 2. This provision, as ISDA commented, will reduce legal uncertainty because ''[it] deal[s] directly with the main source of legal risk under the CEA.'' CL 24–8 at 5.

The expansion of the exemption to cover all bilateral ''contracts, agreements and transactions'' was endorsed by most other commenters. As one commenter, Reuters Group PLC, noted, this amendment should permit a ''substantially broader range of transactions to enjoy a new level of legal certainty.'' CL 24–30 at 2. In this regard, the Commission believes that certain pending matters may now be considered within the context of the new regulatory framework.

Two commenters, a coalition of commercial and investment banks (the Coalition)[16] and the OTC Derivatives Products Committee of the Securities Industry Association (SIA), recommended two changes regarding the operation of the exemption. CL 24–31; CL 24–36. First, they suggested that the Commission delete the requirement of the exemption that, in cases where a transaction is not submitted for clearing,[17] the creditworthiness of the counterparty be a material consideration in entering into the transaction. These commenters believe that retention of the creditworthiness requirement for non-cleared transactions will create uncertainty and confusion as to what types of non-cleared transactions are permissible. The Commission agrees and has deleted the creditworthiness requirement from part 35.

The Coalition and SIA also recommended that rule 35.2(d) be amended to authorize explicitly the netting of deliveries or delivery obligations in connection with transactions pursuant to part 35. Currently, part 35 permits bilateral arrangements for the netting of *payment obligations.* It also permits multilateral arrangements for the netting of *payments* ''provided that the underlying gross obligations among the parties are not extinguished until all netted obligations are fully performed.'' 58 FR at 5591. SIA commented that many categories of OTC derivatives require or permit settlement by delivery, that it can see no policy reason for excluding netting of such deliveries while permitting netting of payments, and that permitting such netting would be consistent with the goal of reducing systemic risk for OTC derivatives. CL 24–36 at 10. In light of these comments, the Commission is clarifying that the types of netting agreements that are permissible under part 35 include arrangements for the netting of delivery obligations or deliveries, respectively. As is currently the case for multilateral netting of payments, multilateral netting of deliveries would be permitted provided that the underlying gross obligations among the parties are not extinguished until all netted obligations are fully performed.

ISDA, the Coalition and SIA suggested that the Commission clarify that the determination whether a party is an eligible participant is to be determined by whether there was a reasonable belief at the time the transaction was entered into that a party was an eligible participant. CL 24–8 at 3; CL 24–31 at 8; CL 24–36 at 8. The language of the exemption currently tracks the language of the statute, which provides that the Commission shall not grant an exemption under section 4(c) of the Act unless the Commission determines that the exempted transaction ''will be entered into solely between appropriate persons.'' 7 U.S.C. 6(c)(2)(B)(i). However, as the Commission noted when it adopted the swaps exemption in 1993 (58 FR at 5589; footnotes omitted):

> As the Act specifies that the swap agreement may only be ''entered into'' by appropriate persons, this determination is to be made at the inception of the transaction. Further, it is sufficient that the parties have a reasonable basis to believe that the other party is an eligible swap participant at such time.

Furthermore, the Commission notes that the nonrepudiation provision specifically exempts a party from a rescission action based solely on the failure of the agreement to comply with the terms of the exemption when that party entered into the agreement with an eligible participant or with a counterparty ''reasonably believed by such party at the time the transaction was entered into'' to be an eligible counterparty.[18]

As part of its proposed amendments to part 35, the Commission proposed to publish its Swaps Policy Statement as Appendix A to part 35 and to include its Swaps Policy Statement and its Statutory Interpretation Concerning Certain Hybrid Instruments (55 FR 13582 (April 11, 1990)) (Hybrid Interpretation) within the nonrepudiation provision. The commenters generally supported these proposals, but recommended that the Commission update the Swaps Policy Statement, provide additional relief regarding the Treasury Amendment (7 U.S.C. 2(ii)) and revise and update the Hybrid Interpretation. CL 24–31 at 14–16; CL 24–36 at 3–7. As the Commission has noted, nothing in these rules affects the continuing vitality of the Commission's existing exemptions, policy statements or interpretations. The Commission is persuaded, however, that these commenters have raised important issues which, although outside the scope of this rulemaking, should be addressed expeditiously. The Commission plans to address these issues through a separate rulemaking or other appropriate action.

B. Eligible Participants

A number of commenters suggested changes to the definition of ''eligible participant'' in rule 35.1. The Commission proposed applying the definition of eligible participant set forth in the 1993 swaps exemption[19] to the revised and amended bilateral transaction exemption in part 35. Two commenters, the Managed Funds Association (MFA) and the Futures

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beforehand that the agreement, instrument, or transaction for which an exemption is sought is subject to the Act. Rather, this provision provides flexibility for the Commission to provide legal certainty to novel instruments where the determination as to jurisdiction is not straightforward.

H.R. Rep. No. 978, 102d Cong., 2d Sess. 82–83 (1992). The Commission did not make a determination in 1993 that the transactions that it was exempting under part 35 were or were not subject to its jurisdiction. The Commission similarly declined to make any such determination in proposing the current amendments to part 35 and will not make any such determination now.

[16] See note 8, *supra.*

[17] For rules pertaining to clearing, see part 39 which the Commission is adopting in a companion release in this edition of the **Federal Register**.

[18] The Commission has made a technical change to the nonrepudiation provision in rule 35.3(b) to make clear that the reasonable belief is to exist at the time the transaction is entered into. In addition, the Commission has reorganized the nonrepudiation provisions of section 35.3.

[19] That definition generally uses the list of ''appropriate persons'' set forth in section 4(c)(3)(A) through (J) of the Act, and utilizes the authority granted by section 4(c)(3)(K) to determine other persons to be appropriate persons (specifically, natural persons with total assets exceeding at least $10 million). The Commission placed certain financial and other limitations on various categories of appropriate persons, consistent with Congress' intent that the Commission may limit the terms of an exemption to some, but not all, of the listed categories of appropriate persons. See H.R. Rep. No. 978, 102nd Cong., 2d Sess. 79 (1992).

Industry Association (FIA), suggested that the Commission create a new category of eligible participant that would include certain large commodity trading advisors. CL 24–4 at 4; CL 24–12 at 11. Specifically, MFA and FIA suggested that commodity trading advisors (CTAs) with at least $25 million in assets under management be permitted to trade in all exempt markets on behalf of their customers, without regard to the individual customers' financial qualifications. FIA also suggested that registered investment advisers (IAs) with at least $25 million in assets under management be included in this category of eligible participant.

Several other commenters suggested additional modifications to the definition of eligible participant. ISDA, the Coalition, The EBS Partnership and SIA recommended that the definition of eligible participant be expanded to include several additional categories of financial institutions and to include agency transactions by eligible participants on behalf of other eligible participants. CL 24–8; CL 24–31; CL 24–34; CL 24–36. Certain commenters, including the California Power Exchange, the National Grain and Feed Association (NGFA) and the Weather Risk Management Association, suggested that the financial thresholds for corporations and other entities were too restrictive. CL 24–5; CL 24–10; CL 24–28. Other commenters, including the FIA, the Coalition and SIA, commented that the financial threshold for natural persons who enter into exempt transactions for risk management purposes should be reduced from a total asset test of $10 million to a total asset test of $5 million. CL 24–12; CL 24–31; CL 24–36. Finally, the National Futures Association suggested that the Commission impose a $5 million asset test on investment companies to conform the standard for those collective investment vehicles to that which applies to commodity pools. CL 24–4.[20]

After careful consideration of these comments, the Commission is modifying the definition of eligible participant to permit agency transactions by eligible participants on behalf of other eligible participants,[21] to include foreign banks and their U.S. branches and agencies and the regulated subsidiaries and affiliates of insurance companies within that definition and to include a $5 million asset test for investment companies (as is required for investment companies under the current part 36). The Commission will consider MFA's and NFA's suggestion that a new category of eligible participant be added for registered CTAs and IAs with at least $25 million in assets under management in conjunction with its subsequent review of relief for CPOs and CTAs.[22]

In response to the comments regarding expanding the categories of eligible financial institutions and reducing the financial thresholds for corporations and other entities, the Commission notes that the current definition of eligible participant contains a general corporate category, which itself contains alternative means of qualifying, and that this general corporate category enables many different types and sizes of entities (including financial institutions) to qualify as eligible participants under part 35. As the Coalition acknowledges (CL 24–31 at 6), many financial institutions that are not specifically encompassed by the definition of eligible participant fall within this general corporate category. The Commission believes that this general corporate category is an appropriate standard to determine corporate eligibility.[23]

C. Agricultural Trade Options

Finally, the NGFA and Cargill opined that the bilateral transaction exemption should be available for all transactions in the agricultural commodities enumerated in section 1a(3) of the Act, including agricultural trade options. CL 24–10 at 3; CL 24–15 at 1–2. The Commission is retaining in part 35 its reservation of rule 32.13 which governs trading in certain agricultural trade options at this time.[24] The Commission has not yet had sufficient experience with rule 32.13, which the Commission recently reconsidered and adopted (64 FR 68011 (December 6, 1999)), to determine whether the $10 million net worth level should be modified. Furthermore, at the time the Commission adopted that exemptive level it noted the lack of industry consensus on the issue. *Id.* at 68015. The Commission has no reason to believe that a greater level of consensus has been reached since that time.

The Commission reiterates that these amendments to the part 35 exemption are designed to enhance legal certainty. In adopting these amendments to part 35, the Commission is not making any determination that the exempted transactions are or are not subject to its jurisdiction. When it adopted section 4(c) in 1992, the Conferees of the Congress stated:

> The Conferees do not intend that the exercise of exemptive authority by the Commission [under section 4(c)] would require any determination beforehand that the agreement, instrument, or transaction for which an exemption is sought is subject to the Act. Rather, this provision provides flexibility for the Commission to provide legal certainty to novel instruments where the determination as to jurisdiction is not straightforward.[25]

Moreover, these changes in no way call into question any transaction undertaken under part 35 before the adoption of these amendments. In recognition of its continuing vitality and to assist the public in locating it, the Commission as proposed is incorporating its 1989 Swaps Policy

[20] Many commenters also suggested modifications to the Commission's proposed definition of ''multilateral transaction execution facility'' in part 36. These comments are addressed in a companion release being issued by the Commission today adopting final rules governing multilateral transaction execution facilities. In this regard, the Commission notes that the use of the term ''bilateral'' in the title of part 35 does not import any independent requirements regarding the exemption. Taken together, however, part 35 governing bilateral transactions and parts 36 through 38 governing multilateral transactions execution facilities are intended to be seamless in the sense that transactions that do not fall within the definition of multilateral transaction execution facility in part 36 will be considered to be bilateral.

[21] In light of this general agency authorization by eligible participants on behalf of other eligible participants, the Commission is deleting the language in paragraphs 35.1(b)(2)(i), (ix) and (x) which specifically authorizes certain entities such as banks and futures commission merchants that are eligible participants to act in an agency capacity on behalf of other eligible participants. See 7 U.S.C. 6(c)(3)(A), (I) and (J). This specific authorization is now unnecessary.

[22] In a companion release being issued in this edition of the **Federal Register**, however, the Commission has modified the access standards for CTAs to provide that CTAs with at least $25 million under management may trade on a recognized derivatives transaction facility through any registered futures commission merchant. Moreover, in response to the comments of the futures exchanges, in the same companion release being issued today, the Commission has modified the eligibility standards for recognized derivatives transaction facilities to include certain registered floor brokers and floor traders. The Commission, however, is retaining the existing eligibility standards for floor brokers and floor traders when entering into bilateral transactions under part 35 (and when trading on exempt multilateral transaction execution facilities).

[23] Furthermore, with regard to the comments suggesting that some of the financial thresholds in the definition are too restrictive, the Commission notes that the part 35 definition of eligible participant has worked well over the years and that the amounts in real terms are less restrictive than when the exemption was first adopted.

[24] Rule 32.13 includes its own exemption which imposes a different financial threshold than part 35. Under rule 32.13(g), an option is exempt from various regulatory requirements if, among other things, each party to the option has a net worth of not less than $10 million. The Commission has reserved the application of rule 32.13 in part 35, see rule 35.3(a), and it is that reservation to which NGFA and Cargill object.

[25] H.R. Rep. No. 978, 102d Cong., 2d Sess. 82–83 (1992).

Statement as Appendix A to part 35.[26] Finally, the Commission again affirms the continuing applicability of its Energy Interpretation and its Energy Exemption which are not being changed or altered in any way by these part 35 amendments.

III. Section 4(c) Findings

These rule amendments 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, either unconditionally or on stated terms or conditions from any of the requirements of any provision of the Act. For any exemption granted pursuant to section 4(c), the Commission must find that the exemption would be consistent with the public interest. For any exemption granted pursuant to section 4(c) from the requirements of section 4(a), the Commission must further find that the section 4(a) requirements should not be applied to the agreement, contract or transaction to be exempted, that the exemption would be consistent with the public interest and the purposes of the Act, that the agreement, contract or transaction to be exempted would be entered into solely between appropriate persons and that the exemption would 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.[27]

No one commented directly on the Commission's section 4(c) findings. Two U.S. futures exchanges, the Chicago Board of Trade and the Chicago Mercantile Exchange, however, cautioned the Commission to ensure that traditional exchange markets would not be put at an unfair competitive disadvantage within this new regulatory regime contemplated by this and the Commission's companion **Federal Register** releases. CL 24–7 at 12–13; CL 24–17 at 13–14. In this regard, the Commission believes that the regulatory lines that it has drawn are necessary and appropriate to protect the public interests embodied in the Act. Under the framework as a whole, the degree of regulation will turn on whether the market is multilateral, whether the market participants are eligible and whether or not the commodity is susceptible to manipulation. The Commission believes that these are appropriate factors on which to base regulatory differences and that, within the framework, the exchanges will be able to fairly compete with the OTC market.

The proposed exemption for bilateral transactions is available only to appropriate persons. Moreover, these amendments to part 35 will promote financial innovation and fair competition and reduce systemic risk. The Commission further finds that these proposed amendments would have no adverse effect on any of the regulatory or self-regulatory responsibilities imposed by the Act. Finally, the Commission finds that these amendments are consistent with the public interest.

IV. 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 these rules on small entities. A small entity is defined to include, *inter alia,* a ''small business'' and a ''small organization.'' 5 U.S.C. 601(6).[28] The Commission previously has formulated its own standards of what constitutes a small business with respect to the types of entities regulated by it. The Commission has determined that contract markets, futures commission merchants, registered commodity pool operators, and large traders should not be considered small entities for purposes of the RFA.[29]

The Commission believes that it is unlikely that firms defined as small businesses under Section 3 of the Small Business Act could offer or be offered transactions subject to the part 35 exemption and thus be affected by the rules exempting such transactions. See 58 FR 5587, 5593 (January 22, 1993). Further, the amendments to part 35 that the Commission is adopting today remove the requirement that the exempt transactions not be fungible or standardized as to their material economic terms and makes the expanded relief available to a broader category of transactions.

Accordingly, the Chairman, on behalf of the Commission, certifies pursuant to section 3(a) of the RFA, 5 U.S.C. 605(b), that the amendments to part 35 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 the amendments to part 35.

B. Paperwork Reduction Act

The Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3507(d)) imposes certain requirements on federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information as defined by the PRA. As the Commission noted in proposing these amendments, it has determined that the PRA does not apply to these amendments because they do not contain information collection requirements which require the approval of the Office of Management and Budget. No comments were received concerning the Commission's determination in this regard.

List of Subjects in 17 CFR Part 35

Commodity futures, Commodity Futures Trading Commission.

In consideration of the foregoing, and pursuant to the authority contained in the Commodity Exchange Act and, in particular, sections 2, 4, 4c, and 8a thereof, 7 U.S.C. 2, 6, 6c, and 12a, the Commission hereby revises part 35 of title 17 of the Code of Federal Regulations to read as follows:

PART 35—EXEMPTION OF BILATERAL AGREEMENTS

Sec.
35.1 Scope and definitions.
35.2 Exemption.
35.3 Enforceability.
Appendix A to Part 35—Policy Statement Concerning Swap Transactions

Authority: 7 U.S.C. 2, 6, 6c, and 12a.

§ 35.1 Scope and definitions.

(a) *Scope.* The provisions of this part shall apply to any contract, agreement or transaction which may be subject to the Act, and which has been entered into on or after October 23, 1974.

(b) *Definition.* As used in this part, ''eligible participant'' means, and shall be limited to, the following persons or classes of persons, either trading for their own account or through another eligible participant:

(1) A bank or trust company or a foreign bank or a branch or agency of a

[26] The Swaps Policy Statement originally was published at 54 FR 30694 (July 21, 1989). In this republication, the Commission has corrected certain typographical errors that appeared in the original publication.

[27] See 7 U.S.C. 6(c).

[28] ''Small organization,'' as used in the RFA, means ''any not-for-profit enterprise which is independently owned and operated and is not dominant in its field * * *.'' 5 U.S.C. 601(4). The RFA does not incorporate the size standards of the Small Business Administration for small organizations. Agencies are expressly authorized to establish their own definition of small organization. *Id.*

[29] 47 FR 18618–20 (Apr. 20, 1982).

foreign bank (as defined in section 1(b) of the International Bank Act of 1978 (12 U.S.C. 3101(b));

(2) A savings association or credit union;

(3) An insurance company that is regulated by a State or that is regulated by a foreign government and is subject to comparable regulation (including a regulated subsidiary or affiliate of such an insurance company);

(4) An investment company subject to regulation under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) or a foreign person performing a similar role or function subject as such to foreign regulation, *provided* that such investment company or foreign person is not formed solely for the specific purpose of constituting an eligible participant and has total assets exceeding $5,000,000;

(5) A commodity pool formed and operated by a person subject to regulation under the Act or a foreign person performing a similar role or function subject as such to foreign regulation, *provided* that such commodity pool or foreign person is not formed solely for the specific purpose of constituting an eligible participant and has total assets exceeding $5,000,000;

(6) A corporation, partnership, proprietorship, organization, trust, or other entity not formed solely for the specific purpose of constituting an eligible participant:

(i) Which has total assets exceeding $10,000,000, or

(ii) The obligations of which under the contract, agreement or transaction are guaranteed or otherwise supported by a letter of credit or keepwell, support, or other agreement by any such entity referenced in paragraph (b)(6) of this section or by an entity referred to in paragraph (b)(1), (2), (3), (4), (5), (6) or (8) of this section; or

(iii) Which has a net worth of $1,000,000 and enters into the agreement in connection with the conduct of its business; or which has a net worth of $1,000,000 and enters into the agreement to manage the risk of an asset or liability owned or incurred in the conduct of its business or reasonably likely to be owned or incurred in the conduct of its business;

(7) An employee benefit plan subject to the Employee Retirement Income Security Act of 1974 or a foreign person performing a similar role or function subject as such to foreign regulation with total assets exceeding $5,000,000, or whose investment decisions are made by a bank, trust company, insurance company, investment adviser subject to regulation under the Investment Advisers Act of 1940 (15 U.S.C. 80a–1 *et seq.*), or a commodity trading advisor subject to regulation under the Act;

(8) Any governmental entity (including the United States, any state, or any foreign government) or political subdivision thereof, or any multinational or supranational entity or any instrumentality, agency, or department of any of the foregoing;

(9) A broker-dealer subject to regulation under the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*) or a foreign person performing a similar role or function subject as such to foreign regulation: *Provided, however,* that if such broker-dealer is a natural person or proprietorship, the broker-dealer must also meet the requirements of either paragraph (b)(6) or (11) of this section;

(10) A futures commission merchant, floor broker, or floor trader subject to regulation under the Act or a foreign person performing a similar role or function subject as such to foreign regulation: *Provided, however,* that if such futures commission merchant, floor broker, or floor trader is a natural person or proprietorship, the futures commission merchant, floor broker, or floor trader must also meet the requirements of paragraph (b)(6) or (b)(11) of this section; or

(11) Any natural person with total assets exceeding at least $10,000,000.

§ 35.2 Exemption.

A contract, agreement or transaction is exempt from all provisions of the Act and any person or class of persons offering, entering into, rendering advice, or rendering other services with respect to such contract, agreement or transaction, is exempt for such activity from all provisions of the Act (except in each case the provisions enumerated in § 35.3(a)) provided the following terms and conditions are met:

(a) The contract, agreement or transaction is entered into solely between eligible participants either trading for their own account or through another eligible participant;

(b) The contract, agreement or transaction is not entered into and traded on or through a multilateral transaction execution facility as defined in § 36.1 of this chapter; and

(c) The contract, agreement or transaction, if cleared, is submitted for clearance or settlement to a clearinghouse that is authorized under § 39.2 of this chapter.

(d) The provisions of paragraphs (b) and (c) of this section shall not be deemed to preclude:

(1) Arrangements or facilities between parties to such contracts, agreements or transactions that provide for netting of payment or delivery obligations resulting from such contracts, agreements or transactions;

(2) Arrangements or facilities among parties to such contracts, agreements or transactions that provide for netting of payments or deliveries resulting from such contracts, agreements or transactions; or

(3) The use of an electronic or non-electronic market or similar facility used solely as a means of communicating bids or offers by market participants or the use of such a market or facility by a single counterparty to offer to enter into or to enter into bilateral transactions with multiple counterparties.

(e) Any person may apply to the Commission for exemption from any of the provisions of the Act (except section 2(a)(1)(B)) for other arrangements or facilities, on such terms and conditions as the Commission deems appropriate, including but not limited thereto, the applicability of other regulatory regimes.

§ 35.3 Enforceability.

(a) Notwithstanding the exemption in § 35.2, sections 2(a)(1)(B), 4b, and 4o of the Act, § 32.9 of this chapter as adopted under section 4c(b) of the Act, § 32.13 of this chapter, and sections 6(c) and 9(a)(2) of the Act to the extent that they prohibit 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, continue to apply to transactions and persons otherwise subject to those provisions.

(b) A party to a contract, agreement or transaction that is with a counterparty that is an eligible participant (or counterparty reasonably believed by such party at the time the contract, agreement or transaction was entered into to be an eligible participant) shall be exempt from any claim, counterclaim or affirmative defense by such counterparty under section 22(a)(1) of the Act or any other provision of the Act:

(1) That such contract, agreement or transaction is void, voidable or unenforceable, or

(2) To rescind, or recover any payment made in respect of, such contract, agreement or transaction, based solely on the failure of such party or such contract, agreement or transaction to comply with the terms or conditions of the exemption under this part.

(c) A party to a contract, agreement or transaction that is entered into pursuant to the Statement of Policy Concerning Swap Transactions in appendix A to

this part 35 or the Statutory Interpretation Concerning Certain Hybrid Instruments, as the same may be revised by the Commission from time to time, shall be exempt from any claim under section 22(a)(1) of the Act or any other provision of the Act:

(1) That such contract, agreement or transaction is void, voidable or unenforceable, or

(2) To rescind, or recover any payment made in respect of, such contract, agreement or transaction, based solely on the failure of such party, or such contract, agreement or transaction, to comply with the Statement of Policy Concerning Swap Transactions in appendix A to this part 35 or the Statutory Interpretation Concerning Certain Hybrid Instruments, as the same may be revised by the Commission from time to time, respectively, or with any provision of the Act or other Commission rule or exemption, excluding, in the case of this paragraph, any claim for manipulation or fraud arising under a provision of the Act or Commission rules applicable by its terms to a contract, agreement or transaction that is not otherwise subject to regulation under the Act.

Appendix A to Part 35—Policy Statement Concerning Swap Transactions

(a) Background.

(1) Section 2(a)(1)(A) of the Commodity Exchange Act (CEA or Act) grants the Commission exclusive jurisdiction over ''accounts, agreements (including any transaction which is of the character of * * * an 'option' * * *), and transactions involving contracts of sale of a commodity for future delivery traded or executed on a contract market * * * or any other board of trade, exchange, or market. * * *'' 7 U.S.C. 2. The CEA and Commission regulations require that transactions in commodity futures contracts and commodity option contracts, with narrowly defined exceptions, occur on or subject to the rules of contract markets designated by the CFTC.[1] In several recent releases[2] and in response to requests for case-by-case review of various proposed offerings,[3] the Commission has addressed the applicability of the Act and Commission regulations to various forms of commodity-related instruments offered and sold other than on designated contract markets. An overview of off-exchange transactions and issues was commenced by issuance in December 1987 of an Advance Notice of Proposed Rulemaking (Advance Notice). The Advance Notice requested comment concerning, among other things, a proposed no-action position concerning certain commercial transactions, which, as described, would have extended to certain categories of swap transactions.

(2) Based upon careful review of the comments received in response to the Advance Notice, indicating generally a need for greater clarity in this area, representations from market users, and consultations with other federal regulators concerning the issues raised by swap transactions, the Commission is issuing this policy statement to clarify its view of the regulatory status of certain swap transactions. This statement reflects the Commission's view that at this time most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the Act and regulations. This policy statement is intended to recognize a non-exclusive safe harbor for transactions satisfying the requirements set forth in this Appendix.

(b) Safe harbor standards. (1) In determining whether a transaction constitutes a futures contract, the Commission and the courts have assessed the transaction ''as a whole with a critical eye toward its underlying purpose.''[4] Such an assessment entails a review of the ''overall effect'' of the transaction as well as a determination as to ''what the parties intended.''[5] Although there is no definitive list of the elements of futures contracts, the CFTC and the courts recognize certain elements as common to such contracts.[6] Futures contracts are contracts for the purchase or sale of a commodity for delivery in the future at a price that is established when the contract is initiated, with both parties to the transaction obligated to fulfill the contract at the specified price. In addition, futures contracts are undertaken principally to assume or shift price risk without transferring the underlying commodity. As a result, futures contracts providing for delivery may be satisfied either by delivery or offset.

(2) In addition to these necessary elements, the CFTC and the courts also recognize certain additional elements common to exchange-traded futures contracts, including standardized commodity units, margin requirements related to price movements, clearing organizations which guarantee counterparty performance, open and competitive trading in centralized markets, and public price dissemination.[7] These additional elements facilitate the trading of futures contracts on exchanges and historically have developed in conjunction with the growth of organized contract

[1] 7 U.S.C. 6(a), 6c(b), 6c(c). Section 4(a) of the CEA provides, inter alia, that it is unlawful to enter into a commodity futures contract that is not made ''on or subject to the rules of a board of trade which has been designated by the Commission as a 'contract market' for such commodity.'' 7 U.S.C. 6(a). This prohibition does not apply to futures contracts made on or subject to the rules of a foreign board of trade, exchange or market. 7 U.S.C. 6(a). The exchange trading requirement reflects Congress's view that such an environment would control speculation and promote hedging. H.R. Rep. No. 44, 67th Cong., 1st Sess. 2 (1921). See also 7 U.S.C. 5 (Congressional findings concerning necessity for regulation of futures and commodity option transactions). Pursuant to sections 4c(b) and 4c(d), 7 U.S.C. 6c(b) and 6c(d), of the CEA, the Commission has authority to permit transactions in commodity options which do not take place on contract markets. Currently, only two narrow categories of such option transactions exist: trade options (in which the offeree is a ''commercial user'' of the underlying commodity) and dealer options (in which the grantor fulfills the criteria of section 4c(d)(1) of the CEA). See also 54 FR 1128 (January 11, 1989) (Proposed Rules Concerning Regulation of Hybrid Instruments). Final Rules Concerning Regulation of Hybrid Instruments.

[2] 52 FR 47022 (December 11, 1987) (Advance Notice of Proposed Rulemaking); 54 FR 1139 (January 11, 1989) (Statutory Interpretation Concerning Certain Hybrid Instruments); 54 FR 1128 (January 11, 1989) (Proposed Rules Concerning Regulation of Hybrid Instruments). See also 50 FR 42963 (October 23, 1985) (Statutory Interpretation and Request for Comments Concerning Trading in Foreign Currencies for Future Delivery).

[3] The Commission staff's Task Force on Off-Exchange Instruments has addressed a number of proposed offerings of hybrid instruments in a series of published ''no-action'' letters. See, *e.g.,* CFTC Advisory No. 39–88, June 23, 1988 [Interpretative Letter No. 88–10, June 20, 1988, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,262] (notes indexed to dollar/Yen exchange rate); CFTC Advisory No. 45–88, July 19, 1988 [Interpretative Letter No. 88–11, July 13, 1988, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,284] (notes indexed to dollar/Yen exchange rate); CFTC Advisory No. 48–88, July 26, 1988 [Interpretative Letter No. 88–12, July 22, 1988, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,285] (notes indexed to dollar/foreign currency exchange rate); CFTC Advisory No. 58–88, August 30, 1988 [Interpretative Letter No. 88–16, August 26, 1988, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,312] (federally-chartered corporation issuing notes indexed to nationally disseminated measure of inflation published by a U.S. government agency); CFTC Advisory No. 63–88, September 21, 1988 [Interpretative Letter No. 88–17, September 6, 1988, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,320] (fixed-rate debentures with additional payments indexed to the price of natural gas over an established base price); CFTC Advisory No. 66–88, September 23, 1988, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,321 (certificates of deposit with interest payable at maturity indexed in part to the spot price of gold). See also CFTC Advisory No. 18–19, March 17, 1989 (letter dated November 23, 1988, concerning proposed sale of hay for delayed delivery).

[4] CFTC v. Co Petro Marketing Group, Inc., 680 F.2d 573, 581 (9th Cir. 1982).

[5] CFTC v. Trinity Metals Exchange, No. 85–1482–CV–W–3 (W.D. Mo. January 21, 1986) [citing CFTC v. National Coal Exchange, Inc. [1980–1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,424 at 26,046 (W.D. Tenn. 1982)].

[6] See generally, 52 FR 47022, 47023 (December 11, 1987) (citing In the Matter of First National Monetary Corp., [1984–1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 (CFTC 1985)); Letter to the Honorable Patrick Leahy and the Honorable Richard Lugar, Committee on Agriculture, Nutrition and Forestry, United States Senate, from Wendy L. Gramm, Chairman, Commodity Futures Trading Commission, dated May 16, 1989 (Attachment at 7–8). The Commission has explained that this does not mean that ''all commodity futures contracts must have all of these elements * * *'' In re Stovall, [1977–1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 (CFTC 1979). To hold otherwise would permit ready evasion of the CEA.

[7] E.g., Advance Notice, 52 FR 47023; Letter to the Honorable Patrick Leahy and the Honorable Richard Lugar, Committee on Agriculture, Nutrition and Forestry, United States Senate, from Wendy L. Gramm, Chairman, Commodity Futures Trading Commission, dated May 16, 1989 (Attachment at 8); OGC Statutory and Regulatory Interpretation (Regulation of Leverage Transactions and Other Off-Exchange Future Delivery-Type Instruments), 50 FR 11656, 11657, n.2 (March 25, 1985); CFTC v. Co Petro Marketing Group, Inc., 680 F.2d 573 (9th Cir. 1982).

markets. The presence or absence of these additional elements, however, is not dispositive of whether a transaction is a futures contract.[8]

(3) In general, a swap may be characterized as an agreement between two parties to exchange a series of cash flows measured by different interest rates, exchange rates, or prices with payments calculated by reference to a principal base (notional amount).[9] Commenters have described the swap market as one in which the customary large transaction size effectively limits the market to institutional participants rather than the retail public.[10] Market participants also have noted that swaps typically involve long-term contracts, with maturities ranging up to twelve years.[11] In addition to these characteristics, many comparisons between swaps and futures contracts have stressed the tailored, non-standardized nature of swap terms; the necessity for particularized credit determinations in connection with each swap transaction (or series of transactions between the same counterparties); the lack of public participation in the swap markets; and the predominantly institutional and commercial nature of swap participants. Other commenters have stressed that, despite these distinctions in the manner of trading of swaps and exchange products, the economic reality of swaps nevertheless resembles that of futures contracts.

(4) The Commission recognizes that swaps generally have characteristics, such as individually-tailored terms, predominantly commercial and institutional participants, and expectation of being held to maturity, rather than offset during the term of the agreement, that may warrant distinguishing them from futures contracts. The criteria set forth in this Appendix identify certain swaps for which regulation under the CEA and Commission regulations is unnecessary. These safe harbor standards are consistent with policies reflected in the CEA's jurisdictional exclusion for forward contracts,[12] the Treasury Amendment,[13] and the trade option exemption,[14] and are otherwise consistent with section 2(a)(1)(A) of the CEA. Although these jurisdictional and exemptive or exclusionary provisions are not sufficiently broad to provide clear exemptive boundaries for many swaps, they reflect policies relevant to the safe harbor policy set forth in this Appendix and may encompass certain swap transactions.[15]

(5) Consequently, the Commission has determined that a greater degree of clarity may be achieved through safe harbor guidelines establishing specific criteria for swap transactions to which the Commission's regulatory framework will not be applied. Swaps satisfying the requirements set forth in this Appendix will not be subject to regulation as futures or commodity option transactions under the Act and regulations. This policy statement addresses only swaps settled in cash, with foreign currencies considered to be cash.[16]

(i) Individually-tailored terms. (A) Individual tailoring of the terms of swap agreements is frequently cited as indispensable to the operation of the swap market. Commenters have indicated that swap agreements are based upon individualized credit determinations and are tailored to reflect the particular business objectives of the counterparties. Tailoring occurs through private negotiations between the parties and may involve not only financial terms but issues such as representations, covenants, events of default, term to maturity, and any requirement for the posting of collateral or other credit enhancement. Such tailoring and counterparty credit assessment distinguish swap transactions from exchange transactions, where the contract terms are standardized and the counterparty is unknown. In addition, the tailoring of swap terms means that, unlike exchange contracts, which are fungible, swap agreements are not fully standardized.

(B) To qualify for safe harbor treatment, swaps must be negotiated by the parties as to their material terms, based upon individualized credit determinations, and documented by the parties in an agreement or series of agreements that is not fully standardized.[17] This requirement is intended to exclude from safe harbor treatment instruments which are fungible and therefore may be readily transferred and traded.

(ii) Absence of exchange-style offset. (A) Exchange-traded futures contracts generally

[8] In addition, the Commission and the courts have consistently recognized that ''the requirement that a futures contract be executed on a designated contract market is what makes the contract legal, not what makes it a futures contract.'' In the Matter of First National Monetary Corp., [1984–1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 at 30,975 (CFTC 1985); In re Stovall, [1977–1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 at 23,776 (CFTC 1979). See, also, Interpretative Statement, ''The Regulation of Leverage Transactions and Other Off-Exchange Future Delivery Type Investments-Statutory Interpretation,'' 50 FR 11656 (March 25, 1985).

[9] See generally, Bank for International Settlements, Recent Innovations in International Banking at 37–60 (April 1986); S.K. Henderson, ''Swap Credit Risk: A Multi-Perspective Analysis,'' 44 Business Lawyer 365 (1989). Interest rate swaps have been described as having three primary forms: coupon swaps (fixed rate to floating rate swaps); basis swaps (swap of one floating rate for another floating rate); and cross-currency interest rate swaps (swaps of fixed rate payments in one currency to floating rate payments in another currency). Currency swap transactions involve agreements between two parties providing for exchanges of amounts in different currencies which are calculated on the basis of a pre-established interest rate, a specified exchange rate, and a specified notional amount. Commodity swaps generally include swap transactions similar in structure to interest rate swaps, except that payments are calculated by reference to the price of a specified commodity, such as oil.

[10] The average notional amount for swaps has been estimated at $24 million. Letter from the New York Clearing House to CFTC, dated April 6, 1989, commenting on Proposed Rule and Statutory Interpretation Concerning Certain Hybrid and Related Instruments.

[11] E.g., Letter to CFTC from the International Swap Dealers Association, Inc., dated April 8, 1988, concerning Advance Notice; letter to CFTC from Morgan Guaranty Trust Company of New York, dated April 11, 1988, concerning Advance Notice.

[12] Section 2(a)(1)(A) of the CEA provides that the term ''future delivery'' does not include sales of any cash commodity for deferred shipment or delivery. 7 U.S.C. 2. Sales of cash commodities for deferred delivery, or forward contracts, generally have been recognized to be commercial, merchandising transactions in physical commodities entered into by commercial counterparties who have the capacity to make or take delivery of the underlying commodity but in which delivery ''may be deferred for purposes of convenience or necessity.'' 52 FR 47027; In re Stovall, [1977–1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 at 23,777–78 (CFTC 1979). The forward contract exclusion may apply to certain types of swap transactions.

[13] The Treasury Amendment provides that ''[n]othing in this Act shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade.'' 7 U.S.C. 2. See generally, 50 FR 42963 (October 23, 1985) (CFTC Statutory Interpretation). See also, Commodity Futures Trading Commission v. American Board of Trade, 473 F. Supp. 117 (S.D.N.Y. 1979), aff'd, 803 F.2d 1242 (2d Cir. 1986). The Treasury Amendment may apply to some types of transactions also characterized as swaps.

[14] The trade option exemption, which is set forth in Rule 32.4(a), 17 CFR 32.4(a) (1988), authorizes commodity option transactions, other than those on commodities specified in rule 32.2(a), that are not executed on a designated contract market and that are:

Offered by a person which has a reasonable basis to believe that the option is offered to a producer, processor, or commercial user of, or a merchant handling the commodity which is the subject of the commodity option transaction, or the products or byproducts thereof, and that such producer, processor, commercial user or merchant is offered or enters into the commodity option transaction solely for purposes related to its business as such. It should be noted that under Rule 32.4(a), only the offeree of the trade option need qualify as a ''commercial user'' or ''merchant.'' Rule 32.4(a) is silent concerning which party to a trade option may be the option buyer of a put or call or ''long,'' and which party may be the option seller of a put or call or ''short.'' As a result, provided that the qualifying commercial offeree is entering the trade option transaction solely for non-speculative purposes demonstrably related to its commercial business in the commodity which is the subject of the option transaction, the requirements of Rule 32.4(a) are met.

[15] The forward contract exclusion facilitates commodity transactions within the commercial merchandising chain. The trade option exemption similarly may be viewed as facilitating principal-to-principal transactions in which the offeree is a commercial party with respect to the underlying commodity. The Treasury Amendment reflects Congressional intent to avoid duplicative regulation of foreign currency transactions and other transactions in the interbank market supervised by bank regulatory agencies.

[16] As noted previously, certain categories of swap transactions may be subject to the forward contract exclusion, the Treasury Amendment and the trade option exemption. The safe harbor criteria set forth in this Appendix apply equally to options on swaps.

[17] Formation of swaps pursuant to a master agreement between two counterparties that establishes some or all contract terms for one or more individual swap transactions between those counterparties is not precluded by this requirement, provided that material terms of the master agreement and transaction specifications are individually tailored by the parties.

may be terminated by offset,[18] that is, liquidated through establishment of an equal and opposite position. For exchange-traded futures contracts, the universal counterparty to each cleared position is the clearing organization. Prior consent of the clearing organization, as counterparty, is unnecessary to offset.[19]

(B) In contrast, swap transactions have been described as transactions which create performance obligations terminable only with counterparty consent and which generally are expected to be maintained to maturity. A swap counterparty who seeks to eliminate the economic effect of a swap agreement may enter into a reverse swap agreement, that is, a second swap with the same maturity and payment requirements, with the same or a new counterparty, but in which the party seeking to eliminate its economic exposure assumes the reverse position (in this case the obligations of each party to both transactions continue to maturity). A swap counterparty who seeks to terminate, absent default, its obligations under a swap agreement may: Undertake a swap sale in which, based upon consent of the counterparty, it assigns its rights and obligations under the swap to a third party or negotiate an early termination of the transaction, or swap ''closeout,'' in which it negotiates a lump-sum payment with its counterparty to terminate the swap.[20] In the latter two cases, termination of the obligations created by a swap is dependent upon consent of the counterparty.

(C) To qualify for safe harbor treatment, the swap must create obligations that are terminable, absent default, only with the consent of the counterparty. If consent to termination is given at the outset of the agreement and a termination formula or price fixed, the consent provision must be privately negotiated. This requirement is intended to confine safe harbor treatment to instruments that are not readily used as trading vehicles, that are entered into with the expectation of performance, and that are terminated as well as entered into based upon private negotiation.

(iii) Absence of clearing organization or margin system. (A) As noted in paragraph (b)(5)(ii) of this Appendix, the necessity for individualized credit determinations has been described as a hallmark of swap transactions. A number of commenters have stressed both the dependence of the current swap market on such determinations and the absence of a multilateral ''credit support'' mechanism, such as a clearing organization, for swaps. In accordance with the concept of swaps as dependent upon private negotiation and individualized credit determinations as to the capacity of certain parties to perform, this safe harbor is applicable only to swap transactions that are not supported by the credit of a clearing organization and that are not primarily or routinely supported by a marked-to-market margin and variation settlement system designed to eliminate individualized credit risk.[21] The ability to impose individualized credit enhancement requirements to secure either changes in the credit risk of a counterparty or increases in the credit exposure between two counterparties consistent with the criteria in paragraph (b)(5)(ii) would not be affected.

(B) [Reserved]

(iv) The Transaction is Undertaken in Conjunction With a Line of Business.

(A) The absence of public participation in the swaps market has frequently been cited as a factor supporting different regulatory treatment of swaps and futures contracts. Swap market participants are predominantly institutional and commercial entities such as corporations, commercial and investment banks, thrift institutions, insurance companies, governments, and government-sponsored or chartered entities.[22]

(B) The safe harbor set forth in this Appendix is limited to swap transactions undertaken in conjunction with the parties' line of business.[23] This restriction is intended to preclude public participation in qualifying swap transactions and to limit qualifying transactions to those based upon individualized credit determinations. This restriction does not preclude dealer transactions in swaps undertaken in conjunction with a line of business, including financial intermediation services.

(v) Prohibition Against Marketing to the Public. Swap transactions eligible for safe harbor treatment may not be marketed to the public. This restriction reflects the institutional and commercial nature of the existing swap market and the Commission's intention to restrict qualifying swap transactions to those undertaken as an adjunct of the participant's line of business.

(c) Conclusion. This policy statement is intended to clarify the regulatory treatment of certain transactions in order to facilitate legitimate market transactions in a field distinguished by innovation and rapid growth. Consequently, the Commission proposes to continue to review on a case-by-case basis transactions that do not meet the criteria set out in this Appendix and that are not otherwise excluded from Commission regulation.

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

Jean A. Webb,

Secretary of the Commission.

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[18] In the context of exchange-traded futures, offset refers to the liquidation of a futures position through the acquisition of an opposite position. Availability of such offset, resulting in the liquidation of the position, typically is established by exchange rules governing exchange members' relationships with the clearing house. See, e.g., Chicago Mercantile Exchange Rule 808 (''a clearing member long or short any commodity to the Clearing House as a result of substitution may liquidate the position by acquiring an opposite position for its principal''); Board of Trade Clearing Corporation Regulation 705.00 (''Where a member buys and sells the same commodity for the same delivery, and such contracts are cleared through the Clearing House, the purchases and sales shall be offset to the extent of their equality, and the member shall be deemed a buyer from the Clearing House to the extent that his purchases exceed his sales, or a seller to the Clearing House to the extent that his sales exceed his purchases''); New York Futures Exchange Rule 3–4 (''As between the Clearing Corporation and the original parties to futures contracts and option contracts, such contracts shall be binding upon the original parties until liquidated by offset, delivery, exercise or expiration, as the case may be''). Of course, the ability to offset in any given case depends upon the availability of a counterparty to enter into an offsetting transaction at an acceptable price.

[19] However, the ability to liquidate contractual positions through offset is established by clearing organization rules to which all clearing members consent.

[20] Swap parties may agree in advance upon a termination formula or price for the swap.

[21] Several commenters urged the Commission to adopt a safe harbor for swaps that would be conditioned upon, among other things, the absence of a credit support mechanism. See Letter to CFTC from Sullivan & Cromwell, dated April 8, 1988, concerning Advance Notice, at 41–42; Letter to CFTC from Manufacturers Hanover, dated April 11, 1988, concerning Advance Notice, at 4. The safe harbor standard is based upon individualized credit determinations at the outset and during the pendency of the contract.

[22] Letter dated April 8, 1988, to CFTC from International Swap Dealers Associations, Inc. concerning Advance Notice.

[23] Swap transactions entered into with respect to exchange rate, interest rate, or other price exposure arising from a participant's line of business or the financing of its business would be consistent with this standard.