



# Federal Register

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## Part III

# Commodity Futures Trading Commission

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17 CFR Part 1, et al.

**A New Regulatory Framework for  
Multilateral Transaction Execution  
Facilities, Intermediaries and Clearing  
Organizations; Exemption for Bilateral  
Transactions; Proposed Rules**

## COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 1, 5, 15, 20, 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:** Proposed rulemaking.

**SUMMARY:** The Commodity Futures Trading Commission (Commission or CFTC) is proposing 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 from many of the current rules applicable to designated contract markets. In addition, the proposed framework to a large degree 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 proposing new rules for intermediaries and regulations applicable to entities that clear derivative transactions. These notices propose far-reaching and fundamental changes to modernize Federal regulation of commodity futures and option markets. The Commission also is proposing in a companion release published in this edition of the **Federal Register** to expand and to clarify 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 proposed rules would affect the application of any statutory exclusion, including in particular, the applicability of the exclusion under section 2(a)(1)(A)(ii), popularly known as "the Treasury Amendment."

**DATES:** Comments must be received by August 7, 2000.

**ADDRESSES:** Comments should be sent to the Commodity Futures Trading

Commission, Three Lafayette Centre, 1125 21st Street, NW., Washington, DC 20581, attention: Office of the Secretariat. Comments may be sent by facsimile transmission to (202) 418-5521 or, by e-mail to secretary@cftc.gov. Reference should be made to "Regulatory Reinvention."

**FOR FURTHER INFORMATION CONTACT:** Paul M. Architzel, Chief Counsel, Division of Economic Analysis, or Alan L. Seifert, Deputy Director or Riva Spear Adriance, Attorney-Advisor, Division of Trading and Markets, Commodity Futures Trading Commission, Three Lafayette Centre, 1125 21st Street, NW., Washington, DC 20581. Telephone: (202) 418-5260. E-mail: (P)Architzel@cftc.gov, (A)Seifert@cftc.gov or (R)Adriance@cftc.gov.

#### SUPPLEMENTARY INFORMATION:

##### I. Background

###### A. Overview

The Commission is proposing a new regulatory framework to apply to multilateral transaction execution facilities that trade contracts for the purchase or sale of a contract for future delivery or commodity options. The Commission believes that this new structure will promote innovation, maintain U.S. competitiveness, and at the same time reduce systemic risk and protect customers. The proposed framework does not require that U.S. futures exchanges change their method of operation in any way. However, the markets are poised to undergo rapid change as they continue to meet the competitive challenges posed by technological advances. The new framework provides U.S. futures exchanges the flexibility to respond to these challenges by offering a level of regulation tailored to three alternative types of markets.

Specifically, the Commission is proposing 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).<sup>1</sup> The Core Principles are tailored to match the degree and manner of regulation to the varying nature of the products traded

<sup>1</sup> Products subject to the special procedural provisions of section 2(a)(1)(B) of the Act would continue to be designated and regulated by the Commission as contract markets.

thereon, and to the sophistication of customers.

Under the proposed framework, current U.S. futures exchanges would be included automatically in the RFE category. These exchanges would receive the immediate benefits associated with complying with core principles rather than the prescriptive regulations now in place. In addition to achieving greater flexibility in their current operations, the exchanges also could choose to operate as a DTF or as an exempt MTEF, where appropriate, and be subject to a lesser degree of regulation for many of the commodities that they trade. Or they could operate a combination of the three. The business choice would be theirs.

The Commission is proposing that a category of multilateral transaction execution facilities known as "Derivatives Transaction Facilities," which is geared toward institutional or commercial traders, be subject to an intermediate level of regulation. DTFs, like RFEs, would be Commission-recognized markets. Futures exchanges, if they choose, also may operate as a DTF for those commodities with deliverable supplies sufficiently large to render them eligible for such an intermediate level of regulation.

Although DTFs are intended primarily for institutional traders, the proposed rules provide the individual DTF the flexibility to decide whether or not to include non-institutional traders. The Commission is proposing, 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, certain commercial markets may operate as DTFs for any commodity, other than the agricultural commodities enumerated in section 1a(3) 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. A market that is eligible to be an exempt MTEF, which is discussed below, may voluntarily become a DTF in order to become a "recognized" market.

The Commission also is proposing an exemption for facilities on which transactions are entered into among institutional traders in contracts based upon 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. These commodities are highly unlikely to be susceptible to manipulation. These facilities (exempt MTEFs) would be exempt from all of the requirements of

the Commodity Exchange Act (Act or CEA) and Commission rules, except for anti-fraud and anti-manipulation provisions and a requirement that if performing a price discovery function they provide pricing information to the public. The proposed rules also include a provision that a violation of the terms of the exemption would not render 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. The following chart summarizes the proposed framework:

#### SUMMARY OF FRAMEWORK FOR MULTILATERAL TRADE EXECUTION FACILITIES

Market	Characteristics	Requirements
Recognized Futures Exchange (RFE) .....	1. Any commodity; 2. Any trader	Fifteen Core Principles.
Recognized Derivatives Transaction Facility (DTF) <sup>2</sup> .	1. Only commodities: (a) included in box below; or (b) individual contracts on a case-by-case basis; or 2. Only commercial traders	Seven Core Principles.
Exempt Multilateral Transaction Facility (Exempt MTEF).	1. Only for the following commodities: (a) a debt obligation; (b) a foreign currency; (c) an interest rate; (d) an exempt security (e) a measure of credit quality; (f) an occurrence or contingency beyond the control of the counterparties; or (g) cash-settled based upon an economic or commercial index or measure; and 2. Only institutional traders	1. Anti-fraud section of the CEA; 2. Anti-manipulation section of the CEA; and 3. May not hold self out as regulated.

These proposed rules, along with those proposed in the companion releases on intermediaries and clearing organizations, comprise a new regulatory framework which is 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.

To ensure that the Commission's regulations address regulatory goals in the least costly and burdensome manner consistent with achieving the Commission's mission, the Commission has reviewed its proposed regulatory framework in relation to the four primary objectives of the Act: Ensuring market and price integrity; protecting against market manipulation; protecting the financial integrity of the markets; and protecting customers from abusive trading and sales practices. The proposed amendments would move the Commission from a direct to an

oversight regulator, replacing prescriptive rules with broad performance standards in the form of core principles. The core principles are proposed to be supplemented with statements of guidance on practices that comply with the standards and, only as necessary, implementing rules. The proposed framework reflects differences in regulation of individual markets due to the nature of the commodity traded and the sophistication of market participants. Moreover, the proposed framework adheres to internationally-accepted guidance regarding appropriate regulatory measures for exchange-traded derivatives markets.

The Commission was encouraged in this undertaking by the other Federal financial regulators that comprise the President's Working Group on Financial Markets<sup>3</sup> and by the chairmen of the

<sup>3</sup> Recognizing the importance of the OTC derivatives markets, the Chairmen of the Senate and House Agriculture Committees requested that the President's Working Group on Financial Markets (PWG) 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.

Commission's Congressional oversight committees. Specifically, by letter dated November 30, 1999, the Chairmen of the Senate and House Agriculture Committees, joined by additional senior Senators and Members of the House of Representatives, "encourag[ed] the Commission to use the exemptive authority granted it by the Commodity Exchange Act to lessen regulatory burdens on United States' futures markets so that they may compete more effectively."

#### *B. Changing Nature of Exchange-Traded Markets*

The proposed new regulatory framework responds to changes that have occurred in markets operating under the CEA. Exchange-traded derivatives markets have changed dramatically over the last twenty-five years. Since the last major revision of the regulatory scheme in 1974, the majority of futures trading volume has shifted from agricultural commodities to financial commodities. Moreover, in

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.

<sup>2</sup> As noted above, although DTFs are geared toward sophisticated or institutional traders, the framework would permit a facility eligible to be a DTF based upon the nature of the commodities traded to choose to include non-institutional traders.

1974, no contracts were cash-settled. Today, many are. Over the past twenty-five years the markets also have become increasingly institutional. In addition, the exchanges themselves have matured. During the last twenty-five years they have developed better audit trails, have markedly improved their self-regulatory and surveillance programs and have placed in effect greater safeguards against conflicts of interest in decision-making. They have entered into arrangements with both domestic and foreign exchanges to share surveillance information in order better to carry out their functions. They also have introduced for trading a remarkable range of new commodities.

The competitive environment for United States futures exchanges also has changed dramatically during the last twenty-five years. Although futures trading was always global in nature, aggregate trading volume on non-U.S. futures and option exchanges has surpassed aggregate trading volume on U.S. exchanges. In addition, exchange-traded derivative markets face increased competition from the over-the-counter markets.

## II. Framework for Multilateral Transaction Execution Facilities

The Commission is proposing a multifaceted framework which includes three broad categories of trading facilities: Recognized Futures Exchanges, Derivatives Transaction Facilities and Exempt MTEFs. The level of oversight applied to exchanges or trading facilities would 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. One constant requirement at all levels of oversight, however, is the need for markets serving a price discovery function to provide a degree of price transparency. This multifaceted approach to oversight is intended to balance 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.

### A. Exempt Multilateral Transaction Execution Facilities (Exempt MTEFs)

The Commission is proposing a new, self-effectuating exemption for those multilateral transaction facilities (MTEFs) meeting the conditions specified in the rule. As proposed, these facilities would be exempt from regulation by the Commission. The exemption would apply to transactions traded on MTEFs that are open for trading only to eligible participants, 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 § 2a(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 corresponding underlying cash market.

The Commission is of 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. In this regard, transactions by eligible participants in these commodities would be exempt from Commission regulation under either the Part 35 exemption for bilateral transactions or under the Part 36 exemption for MTEFs.

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). The 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.

Examples of existing non-dormant, designated contract markets that are based on an eligible debt obligation include CBT U.S. Treasury bonds, CBT Long term U.S. Treasury notes and CME Treasury Bills. The Commission particularly requests comment with respect to inclusion of government securities in the list of commodities that are eligible for the exemption under part 36. In light of the significant regulation of government securities markets under the Government Securities Act of 1986

(as amended)<sup>4</sup> and other securities laws, would granting a broad exemption to contract markets for futures on government securities give rise to significant and undesirable opportunities for regulatory arbitrage?

Examples of eligible foreign currencies include currency contract and currency cross rates. Contracts on an interest rate typically represent interest on time deposits. Because these time deposits generally are non-negotiable, the contracts overlying them are usually cash-settled. Such rates are derived from activity in the interbank market, which is very liquid and deep. A major component of the interbank market is the market for deposits of U.S. dollars held in foreign markets. This market sets the interest rates for dollars held as deposits in these banks. Much of the activity is centered in London and is reflected by the London Interbank Offer Rate (LIBOR). LIBOR is the rate at which the most credit-worthy banks offer to lend to one another. Variable rate loans, deposits, and interest rate swaps are often quoted as a spread over LIBOR. Other active trading centers exist throughout Europe and in other countries in Asia and elsewhere, and the interest rates reported for those markets share similar monikers such as PIBOR (Paris Interbank Offer Rate), FIBOR (Frankfurt Interbank Offer Rate), and TIBOR (Tokyo Offer Rate). Commodities on existing non-dormant designated contract markets eligible for this exemption include CME three month Eurodollars, CME one month LIBOR, CME three month Euroyen, CME three month TIBOR, CME three month Euro Canada and CBT yield curve spreads.

The commodities eligible for exemption include measures of credit risk or quality. This category specifically includes various types of instruments denominated as "total return swaps," "credit swaps," or "credit spread swaps." As noted in a companion release in this issue of the **Federal Register** proposing amendments to the Commission's part 35 exemption, nothing in the rules that the Commission is proposing would affect the continued applicability of any existing Commission exemptions, policy statements or interpretations to such total return swaps or to any other instrument. An example of an existing designated contract market included in this category is the CBT bankruptcy index.

<sup>4</sup> Government Securities Act of 1986, Pub. L. 99-571, 100 Stat. 3208; Government Securities Act Amendments of 1993, Pub. L. 103-202, 107 Stat. 2344.

The final two categories of eligible commodity are for contracts based upon an occurrence or a contingency beyond the control of any trader, or any economic or commercial index or measure not based upon prices derived from trading in a directly corresponding underlying cash market. These instruments must be cash settled, because there is no underlying tangible commodity, financial asset or instrument which could be delivered to settle the contracts at maturity, *i.e.*, there is no direct cash market counterpart. For these types of derivatives, concerns about the potential for manipulation of cash market prices are obviated, since individual traders typically have no ability to influence the value of the cash settlement, and, since the settlement value is not based on the prices of any asset or product traded in a directly corresponding cash market.

Exempt derivative instruments included in this category are contracts that are cash settled based upon an objective measurement of an economic or commercial index, a natural occurrence or a contingency. In this regard, the cash settlement measure could be based on an objective process, such as a count or measurement of a physical property or natural occurrence, or could be calculated by an independent third party that is widely accepted as a reputable provider of data regarding the commodity. Also included in this category are contracts that are settled in cash 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. It is not intended to include contracts based upon a cash-settlement price determined through cash-market trading of any physical commodity or financial instrument, but rather contracts based on the objectively determined results of an outcome, occurrence, or event that is beyond the control of the parties involved in the contract or the entity where trading occurs. Derivatives traders have no ability to influence the final settlement value to profit on a derivatives position, and in many cases, the data used to compile the indexes are publicly available and are generated by reputable sources. 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.

Examples include contracts based on: Weather (such as contracts based on temperatures or precipitation data); the Consumer Price Index or the Gross Domestic Product; insurance data, bankruptcy rates, real estate rental indexes or occupancy (vacancy) rates for individual localities; or measures of physical production or sales amounts such as housing starts or auto sales; or crop yields.

The Commission is proposing 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." The 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." See, 58 FR 5587, 5591 (Jan. 22, 1993). 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.

It should be noted that 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(a). 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. Accordingly, a facility that fits within the definition of "multilateral transaction execution facility" in part 36 may not be a "board of trade" for purposes of the Treasury Amendment.

As proposed, in exercising its authority under these exemptive rules, the Commission would not make 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.<sup>5</sup>

In exercising this 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.<sup>6</sup> Accordingly, 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, or that a similar market voluntarily submits to CFTC oversight as a recognized DTF or RFE, 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. However, the proposed exemptive rules for DTFs and RFEs provide that a market that is eligible to operate as an exempt MTEF but which chooses to become recognized by the Commission as a DTF or RFE, is bound to comply with applicable provisions of the Act and Commission rules as a condition of those exemptions.

#### *B. Derivatives Transaction Facilities*

The Commission also is proposing a new exemptive category for Derivatives Transaction Facilities. A market or similar facility, including a board of

<sup>5</sup> 5 H.R. Rep. No. 978, 102d Cong., 2d Sess. 82-83 (1992).

<sup>6</sup> For instance, 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 (October 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).

trade, would be eligible to become a DTF under proposed part 37, regardless of its method of transmitting bids and offers or its matching system, if the contracts traded on the DTF meet specified commodity eligibility requirements. These are identical to the commodity eligibility requirements for the exempt MTEF.<sup>7</sup> Such DTFs would have the choice of whether or not to permit access to the market by non-eligible traders, but if they did permit such access, it would be allowed only through registered FCMs meeting a number of additional requirements. The intermediary firm and its associated person would be required to meet a number of requirements, including providing their non-institutional customers with enhanced disclosure and additional protections.<sup>8</sup> The DTF, however, may limit access solely to eligible participants if it so chooses.<sup>9</sup>

In addition, under proposed part 37, a facility that restricted participation to "eligible commercial participants" would be eligible to become a DTF to trade contracts based on all commodities other than those domestic agricultural commodities enumerated in section 1(a)(3) of the Act<sup>10</sup> and those commodities subject to the provisions of section 2(a)(1)(B) 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.<sup>11</sup>

<sup>7</sup> 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.

<sup>8</sup> Proposed 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.

<sup>9</sup> Facilities that meet the commodity eligibility requirement and permit access only to institutional traders are thereby eligible to be exempt MTEFs. However, such facilities may choose to seek recognition as a DTF. By choosing to comply with the additional DTF requirements outlined in this framework and thereby becoming recognized, the facility would be acknowledged to have met a higher regulatory standard.

<sup>10</sup> 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.

<sup>11</sup> Many of these trading facilities are expected to replicate electronically various aspects of today's

The Commission is proposing that the agricultural commodities listed in section 1a(3) of the Act not be eligible for trading on a DTF. Because the current futures markets in these commodities tend to be the primary, if not the only, centralized source of price discovery and price basing for these commodities, they have not been included by the Commission in certain regulatory programs, particularly at the time of their initiation.<sup>12</sup> However, members of the agricultural community have at times argued that they should not be prohibited from benefiting from innovative trading practices that are available for non-agricultural commodities. In light of the unique considerations that these commodities present, the Commission is seeking comment from the agricultural community on the advisability of allowing the enumerated agricultural commodities to be traded on a DTF at this time.

Although contracts, agreements or transactions traded on a DTF would be exempt from many of the Act's provisions and Commission regulations,<sup>13</sup> the exemption is contingent upon compliance with the conditions set forth in part 37.<sup>14</sup> Transactions carried out in reliance upon the proposed part 37 exemption would not be voidable as a matter of law due to a violation of the part 37 exemption.

To be recognized as a DTF under proposed part 37 an entity either must have been 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 the Commission's regulations, or must apply to the Commission for

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.

<sup>12</sup> For example, options on agricultural futures contracts were introduced subsequent to options trading on non-agricultural commodities and the enumerated agricultural commodities are not included in the existing Part 36 exemption.

<sup>13</sup> Certain sections of the Act, including the fraud and manipulation provisions of the Act and the Commission's regulations are reserved in proposed rule 37.5 and would continue to apply.

<sup>14</sup> Although exempt from many statutory and regulatory requirements, 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 "board of trade," or a "designated contract market" under the Act. Therefore, the Act would apply to a DTF (and an RFE) as would any other statutory or regulatory provision which refers to "boards of trade" or "designated contract markets." Accordingly, transactions on a DTF would be accorded the same treatment for bankruptcy or tax purposes as transactions on formally designated contract markets.

recognition as a DTF under part 37. Under proposed § 37.3, a DTF must meet certain conditions for recognition. An application should address how the facility has provided for rules relating to trading on its facility, including: (1) Depending on the nature of the trading mechanism, (i) rules to deter trading abuses, and adequate power and capacity to detect, investigate and take action against violation of its trading rules, or (ii) 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 have occurred; (2) rules or terms and conditions defining, or specifications detailing, the operation of the trading mechanism or electronic matching platform; and (3) rules or terms and conditions detailing the financial framework applying to the transactions or ensuring the financial integrity of transactions entered into by, or through, its facilities. The application also should address how the facility would initially, and on a continuing basis, meet and adhere to seven core principles: enforcement, market oversight, operational information, transparency, fitness, recordkeeping and competition.<sup>15</sup>

Guidance on meeting the conditions for recognition is provided in the appendix to part 37. Including information not self-evident from the DTF's rules or trading terms addressing the issues set forth in the appendix to part 37 in an application for recognition would assist the Commission in understanding how the applicant meets and adheres to the conditions for recognition. The guidance in the appendix to part 37, however, is intended to be a safe harbor and not the exclusive method of meeting the part 37 conditions for recognition. A DTF could meet a condition for recognition or support its application through procedures, materials, descriptions or documents other than those described in the part 37 appendix.

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 the applicant and/or its rules or procedures do not violate the Act or the

<sup>15</sup> A board of trade, facility, or entity recognized as a DTF that also maintained a designated contract market or a recognized futures exchange would be required either to clearly identify trading products by market on any electronic system or to provide for separate physical trading locations, depending upon the trading mechanism.

Commission's regulations. An entity seeking recognition as a DTF may request that the Commission approve its initial set of rules under section 5a(a)(12)(A) of the Act and Commission regulations thereunder. Subsequently, the DTF would notify the Commission of additional rules and rule amendments in the same manner that it notifies market participants. A DTF could request that the Commission approve new rules or rule amendments under section 5a(a)(12)(A) of the Act and Commission regulations thereunder. A DTF also could request the Commission to issue an order determining whether the DTF, in adopting and implementing a rule, endeavored to take the least anticompetitive means of achieving the objective, purposes, and policies of the Act.<sup>16</sup>

### C. Recognized Futures Exchanges

The Commission also is proposing significant regulatory relief to futures exchanges from current requirements that are applicable to designated contract markets. All currently designated contract markets, except for those designated as contract markets in section 2(a)(1)(B) commodities, will be afforded this relief. Under proposed part 38, currently designated contract markets will become recognized futures exchanges. Proposed part 38 replaces many prescriptive rules with performance-based rules. These performance-based rules, or Core Principles, will provide recognized futures exchanges with greater operational flexibility. Prescriptive rules relating to audit trail and conflict of interest procedures, for example, will be replaced by more flexible Core Principles. Moreover, the Commission would not require that it approve an RFE's new contracts prior to listing. In addition, except for the terms and conditions of agricultural commodities enumerated in section 1a(3) of the Act, the Commission would not require its

approval of an RFE's rules and rule amendments prior to implementation, although an RFE voluntarily could submit such contracts or rule amendments to the Commission for review and approval. Furthermore, the exchanges would no longer be responsible for auditing intermediaries' sales practices. Instead, enforcement would be the responsibility of a registered futures association. The National Futures Association (NFA) currently is the only such registered organization.

In addition to currently designated contract markets, other multilateral transaction execution facilities could apply for recognition as an RFE. Eligibility for recognition is not limited by the nature of the trader having access to the facility or the nature of the commodities to be traded. Because RFEs may 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, RFE markets potentially have a greater susceptibility to price manipulation and raise greater concerns regarding customer protection than those of DTFs. Therefore, the proposed rules in part 38 preserve a higher level of market surveillance, position reporting obligations, customer protections and financial safeguards than do the rules for DTFs.

In order to be recognized as an RFE, an applicant must meet all of the conditions for recognition specified by proposed rule 38.3. Applicants are to demonstrate how the board of trade, facility or entity has provided for: (1) 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; (2) rules relating to trading on its exchange, including rules to deter trading abuses, and adequate authority 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; (3) 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 defined in the operational rules or specifications; (4) a clear framework for

ensuring the financial integrity of transactions entered into by or through its exchange; (5) established procedures for impartial disciplinary committee(s) or other similar mechanisms empowered to discipline, suspend, or expel members, or to deny access to participants or, if provided for, discipline participants; and (6) arrangements to obtain necessary information to perform the above functions, including the capacity and arrangements to carry out the International Information Sharing Agreement and Memorandum of Understanding developed by the Futures Industry Association (FIA) Global Task Force on Financial Integrity and a mechanism to provide to the public ready access to its rules and regulations.

The application is to address how the exchange initially, and on a continuing basis, meets and adheres to each of part 38's fifteen Core Principles: rule enforcement, products, position monitoring and reporting, position limits, emergency authority, public information, transparency, trading system, audit trail, financial standards, customer protection, dispute resolution, governance, recordkeeping and competition. Guidance on meeting the Core Principles is provided in the appendix to part 38. Information addressing these issues should be included in an application for recognition and should explain to the Commission how the applicant meets and adheres to the conditions for recognition.

Appendix A to part 38 offers general guidance for applicants seeking recognition and also includes a number of proposed statements of acceptable practices for compliance with several Core Principles. These acceptable practices are intended to indicate a manner in which an applicant can meet a Core Principle, but are not meant to be the exclusive means for meeting that Core Principle. Rather, these acceptable practices should be viewed as safe harbors. If an RFE follows an acceptable practice included in the appendix to part 38, it is assured of meeting the relevant Core Principle.

A board of trade, facility, or entity seeking recognition as a recognized futures exchange would be deemed to be recognized sixty days after the Commission received the application unless it appeared that the applicant and/or its rules or procedures might violate a specific provision of the Act or Commission rule that has been reserved under the proposed exemptive rule, or fails to meet one or more of the conditions for recognition in proposed

<sup>16</sup> The Commission is proposing a new part 20 to require traders on DTFs to provide information to the Commission concerning their trading on a DTF in response to a Commission special call for such information. This authority is critical to the Commission's ability to oversee the market. In addition, the Commission is proposing to amend Rule 15.05 by adding paragraphs (e), (f) and (g). The new paragraphs will permit the Commission to obtain information from foreign brokers, any of their customers or a foreign trader trading on a DTF or an RFE regarding their futures or options transactions on the facility or exchange. The amendments extend to foreign persons trading on DTFs or RFEs the requirements of rule 15.05 relative to foreign brokers, their customers and foreign traders whose accounts are maintained by a futures commission merchant or introducing broker.

rule 38.3. In that case, the Commission could notify the applicant that the Commission would review the proposal under section 6 of the Act.

The Commission is proposing amendments to part 5 of its rules to permit RFEs to list new products based only on their certification that the contract and its rules do not violate any applicable provision of the Act or Commission rules. As an aid to exchanges listing new products through this certification procedure, the Commission also is proposing a new statement of guidance relating to Core Principle #2, that contracts listed for trading not be readily susceptible to manipulation. New products listed under this procedure must be labeled as listed pursuant to exchange certification. Alternatively, an RFE could submit a new product for prior Commission review and approval under fast-track procedures. RFEs choosing to submit new contracts for prior approval under fast-track procedures should submit an application which conforms to the requirements of Guideline No. 1, 17 CFR part 5, appendix A.<sup>17</sup> The Commission will approve the terms and conditions of contracts submitted for review. Such contracts may be listed as "approved by the Commission."

Similarly, an RFE may request that the Commission approve amendments to its rules under section 5a(a)(12)(A) of the Act and Commission regulations thereunder. The Commission is proposing a voluntary procedure for the review and approval of exchange rules. Under these procedures, all exchange rule amendments could be submitted for forty-five day fast track review and certain rule amendments could be submitted for expedited review as provided previously by the Commission in approving a general authorizing rule. Alternatively, an RFE could amend its rules (other than the terms or conditions of contracts on the agricultural commodities enumerated in section 1a(3) of the Act) by certification to the Commission that a rule does not violate the Act or Commission rules on the day preceding the rule's implementation.

The certification procedure proposed under the changes to rule 1.41 is similar to a certification procedure published by the Commission as proposed rule 1.41(z) in November of 1999.<sup>18</sup> The

Commission points out, however, that the currently proposed certification procedure includes a stay provision that was not included in the 1.41(z) proposal. That provision is limited to use during any proceeding to disapprove, alter or amend a rule.<sup>19</sup> The decision to impose a stay would not be delegable to any employee of the Commission. The Commission requests comments on this provision.

The Commission is also proposing that it merely be notified on a weekly basis following the implementation of certain specified exchange rule amendments. The Commission need not be notified, even as part of a weekly update, however, of rule changes relating to exchange administration, including those relating to decorum.

#### *D. Deletion of Part 180 and Amendment of Commission Regulation 170.8*

Contract markets are required, under section 5a(a)(11) of the Act, to provide fair and equitable procedures for the settlement of customer claims and grievances against any of its members or such members' employees, whether through arbitration or other dispute resolution programs. The Commission promulgated part 180 (Arbitration or other Dispute Resolution Procedures) to give the contract markets a blueprint for developing the required "fair and equitable" procedures. As part of the regulatory reform process discussed earlier the Commission is proposing to delete part 180. Instead of following the detailed requirements of part 180, the Commission is proposing that RFEs be required to meet the Core Principle for dispute resolution. For contracts in section 2(a)(1)(B) commodities which will continue to be designated contract markets, section 5a(a)(11) of the Act would still require the contract market to provide fair and equitable procedures for the settlement of customer claims and grievances.

The Commission has included an appendix to part 38, as explained above, to provide guidance on meeting the conditions for approval under part 38, including acceptable practices for some of the Core Principles. These acceptable practices, as previously explained, are ways to meet a Core Principle but are not meant to be the only method for meeting that Core Principle. Instead, these acceptable practices should be viewed as safe harbors. Therefore, the guidance on Core Principle 12, dispute resolution, includes acceptable practices for exchange dispute resolution programs as one, but not the only, means for meeting the dispute

resolution Core Principle. The acceptable practices provided in the appendix were based on the principles for arbitration and other dispute resolution settlement procedures under part 180. The guidance on customer dispute resolution found in the appendix to part 38 would also be applicable to derivative transaction facilities that allowed access to non-institutional participants.<sup>20</sup>

The Commission is also proposing to amend § 170.8 of the Commission's regulations as that provision currently requires that the procedures for settlement of customer disputes promulgated by futures associations be consistent with part 180. Under the proposed amendments to § 170.8, programs for resolution of customer claims and grievances promulgated by futures associations would be required to be consistent with the guidelines and acceptable practices found in the appendix to part 38.

### **III. Section 4(c) Findings**

These rule amendments are being proposed 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. To grant such an exemption, the Commission must find that the exemption would be consistent with the public interest, 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.<sup>21</sup>

As explained above, these proposed rules would establish a new regulatory framework. The proposed 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 in the markets. Specifically, the proposed framework would establish three regulatory tiers with regulations tailored to the nature of

<sup>17</sup> Guideline No. 1 was itself recently amended to reduce unnecessary burdens. By and large it merely requires an applicant to file with the Commission the proposed contract's terms and conditions and a completed checklist. This checklist replaces a previously required narrative explanation and justification of the proposed contract's terms and conditions.

<sup>18</sup> 64 FR 66428 (November 26, 1999).

<sup>19</sup> Proposed rule 1.41(c)(1)(iv).

<sup>20</sup> In light of the deletion of part 180, a new rule 166.5 replacing former rule 180.3 relating to the use of pre-dispute arbitration agreements is being proposed in the companion release on intermediaries in today's edition of the **Federal Register**. The substance of the rule as proposed is unchanged from the current requirement.

<sup>21</sup> See, 7 U.S.C. 6(c).

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. Moreover, 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. The Commission believes that, in light of these conditions, the exemptive relief would have no adverse effect on any of the regulatory or self-regulatory responsibilities imposed by the Act. The Commission specifically requests the public to comment on these issues.

#### 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. Information of the type that would be required under the proposed rule does not involve any small organizations.

##### B. Paperwork Reduction Act of 1995

This proposed rulemaking contains information collection requirements. As required by the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)), the Commission has submitted a copy of this section to the Office of Management and Budget (OMB) for its review.

*Collection of Information:* Rules Relating to part 37, Establishing Procedures for Entities to be Recognized as Derivatives Transaction Facilities (DTFs), OMB Control Number 3038-XXXX.

The estimated burden was calculated as follows:

Estimated number of respondents: 10.  
Annual responses by each respondent: 1.

Total annual responses: 10.  
Estimated average hours per response: 200.

Annual reporting burden: 2,000.  
*Collection of Information:* Rules Relating to part 38, Establishing Procedures for Entities to become a Recognized Futures Exchange (RFE), OMB Control Number 3038-XXXX.

The estimated burden was calculated as follows:

Estimated number of respondents: 10.  
Annual responses by each respondent: 1.

Total annual responses: 10.  
Estimated average hours per response: 300.

Annual reporting burden: 3,000.  
*Collection of Information:* Rules Pertaining to Large Trader Reports, OMB Control Number 3038-0009

The estimated burden associated with the elimination of large trader reporting requirements for futures exchanges that operate exempt multilateral trade execution facilities was calculated as follows:

Estimated number of respondents: 4,731.  
Annual responses by each respondent: 14.67.  
Total annual responses: 69,392.  
Estimated average hours per response: 35213.  
Annual reporting burden: 24,435.  
This annual reporting burden of 24,435 hours represents a decrease of 394 hours as a result of the proposed revision.

Organizations and individuals desiring to submit comments on the information collection requirements should direct them to the Office of Information and Regulatory Affairs, Office of Management and Budget, Room 10202, New Executive Office Building, 725 17th Street, NW, Washington, DC 20503; Attention: Desk Officer for the Commodity Futures Trading Commission.

The Commission considers comments by the public on this proposed collection of information in:

Evaluating whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information will have a practical use;

Evaluating the accuracy of the Commission's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used; Enhancing the quality, usefulness, and clarity of the information to be collected; and

Minimizing the burden of collection of information on those who are to respond, including through the use of appropriate automated electronic, mechanical, or other technological collection techniques or other forms of information technology; *e.g.*, permitting electronic submission of responses.

OMB is required to make a decision concerning the collection of information contained in these proposed regulations between 30 and 60 days after publication of this document in the **Federal Register**. Therefore, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days

of publication. This does not affect the deadline for the public to comment to the Commission on the proposed regulations.

Copies of the information collection submission to OMB are available from the CFTC Clearance Officer, 1155 21st Street, NW., Washington DC 20581, (202) 418-5160.

#### List of Subjects

##### 17 CFR Part 1

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

##### 17 CFR Part 5

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 20

Commodity futures, Contract markets, Reporting and recordkeeping requirements.

##### 17 CFR Part 36

Commodity futures, Commodity Futures Trading Commission.

##### 17 CFR Part 37

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

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 Commodity Exchange 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 proposes to amend 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 proposed to be 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 derivatives transactions facility and 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 derivatives transactions facility or recognized futures exchange on which transactions in futures contracts or options 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 proposed to be amended as follows:

a. By removing and reserving paragraph (b),

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

c. By revising paragraphs (c) through (e),

d. By amending paragraphs (f) and (g) by adding the words "or recognized futures exchange" after the words "contract market" each time they appear, and

e. By removing and reserving paragraphs (j) through (t), to read as follows:

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

\* \* \* \* \*

(b) [Reserved]

(c) Exemption from the rule review procedure requirements of Section 5a(a)(12)(A) of the Act and related regulations.

(1) Rules of designated contract markets, recognized futures exchanges and recognized clearing organizations.

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:

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

(ii) 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

(iii) The rule submission includes:  
(A) The label, "Submission of rule by self-certification;"

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

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

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

(iv) 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.

(2) Rules of derivatives transaction facilities. Notwithstanding the rule approval and filing requirements of section 5a(a)(12)(A) of the Act, derivatives transaction facilities may place a rule into effect without prior Commission review or approval if the derivatives transaction facility files 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 (brackets must indicate words deleted and underscoring must indicate words added) 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 implementation of the rule.

(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, 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, derivatives transaction facilities 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, derivatives transaction facility or 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) Non-material 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, derivatives transaction facilities 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, derivatives transaction facility 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.

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

5. Part 5 is proposed to be 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 proposed to be revised as set forth above and §§ 5.1 through 5.4 are proposed to be 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 § 38.3 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 of this part;

(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 neither violate nor are inconsistent with any requirement of part 38 of this chapter, any applicable provision of the Commodity Exchange 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 proceeding to disapprove designation 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 to adopt a specific term or condition, trading rule or procedure, or to take or refrain from taking a specific action.

##### **§ 5.2 Listing products for trading by derivatives transaction facilities.**

Notwithstanding the provisions of section 4(a)(1) of the Act or § 33.2 of this chapter, a recognized derivatives transaction facility under § 37.3 of this chapter may list contracts for trading if it files with the Commission at its Washington, D.C. headquarters, a submission labeled "DTF Notice of Product Listing," which includes the text of the contract's terms or conditions 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.

##### **§ 5.3 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 § 38.3 of this chapter or a recognized derivatives transaction facility under § 37.3 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 § 38.3 of this chapter or by a derivatives transaction facility under § 37.3 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 rule 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.

#### § 5.4 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 5.3 of this part that has become dormant may be relisted for trading additional months pursuant to the procedures of § 1.41(c) 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 § 5.3 of this part and that has become dormant may be relisted for trading additional months pursuant to the procedures of § 1.41(d) 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 of this part 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.

c. Appendices C and D are removed and reserved to read as follows:

**Appendix C—[Reserved]**

**Appendix D—[Reserved]**

#### **PART 15—REPORTS—GENERAL PROVISIONS**

6. The authority citation for Part 15 is proposed to be 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 proposed to be amended 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 or recognized futures exchange that permits a foreign broker to intermediate transactions in futures contracts or options contracts on the facility or exchange, or permits a foreign trader to effect transactions in futures contracts

or options 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 options contracts executed by the foreign broker or the foreign trader on the derivatives transaction facility or recognized futures exchange. Service or delivery of any communication issued by or on behalf of the Commission to a derivatives transaction facility 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 or recognized futures exchange who has been served with, or to whom 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 or recognized futures exchange to permit a foreign broker, any of its customers or a foreign trader to effect transactions in futures contracts or options contracts unless the derivatives transaction facility 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 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 contracts or options 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 or recognized futures exchange prior to effecting any transactions in futures contracts or options contracts on the derivatives transaction facility 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 or recognized futures exchange prior to permitting the foreign broker, any of its customers or the foreign trader to effect any transactions in futures contracts or options 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, NW, 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 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 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 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 transactions facility or recognized futures exchange on which all transactions in futures contracts or options 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. Chapter I of 17 CFR is proposed to be amended by adding a new Part 20 to read as follows:

**PART 20—SPECIAL CALLS RELATING TO TRANSACTIONS ON DERIVATIVES TRANSACTION FACILITIES**

Sec.

- 20.1 Special calls for information from derivatives transaction facilities.  
20.2 Special calls for information from futures commission merchants.

20.3 Special calls for information from participants.

20.4 Delegations of authority.

**Authority:** 7 U.S.C. 6(c), 6i and 12(a)(5).

**§ 20.1 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.

**§ 20.2 Special calls for information from futures commission merchants.**

Upon special call by the Commission, each person registered or deemed to be 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 other facilities or markets, in the form and manner and within the time specified by the Commission in the special call.

**§ 20.3 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 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.

**§ 20.4 Delegation of authority.**

The Commission hereby delegates, until the Commission orders otherwise, the authority to make special calls for information set forth in §§ 20.1, 20.2 and 20.3 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.

9. PART 36 is proposed to be revised to read as follows:

## PART 36—EXEMPTION OF TRANSACTIONS ON MULTILATERAL TRANSACTION EXECUTION FACILITIES

- Sec.  
36.1 Definitions.  
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)–(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 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 transactions between them, including 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 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;
- (2) A foreign currency;
- (3) An interest rate;
- (4) An exempt security or index thereof, as provided in section 2a(1)(B)(iv) 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, extent of 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 corresponding underlying cash market;

(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 by the Commission 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 obligations resulting from such agreements; or

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

(e) The facility must be legally separate from any designated contract market, any recognized futures exchange under part 38 of this chapter and any facility recognized as a derivatives trading facility under part 37 of this chapter;

(f) 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 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 part 38 of this chapter be traded in a location separate from products traded pursuant to this part 36; and

(g) If the Commission determines by order, after notice and an opportunity for a hearing, 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.

(h) Any person or entity may apply to the Commission for exemption from any of the provisions of the Act (except 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 an eligible counterparty (or counterparty reasonably believed by such party to be an eligible counterparty) 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.

10. Chapter I of 17 CFR is proposed to be 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 Conditions for recognition as a derivatives transaction facilities.  
 37.4 Procedures for recognition.  
 37.5 Enforceability.  
 37.6 Fraud in connection with Part 37 transactions.  
 Appendix A to Part 37—Application Guidance

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

### § 37.1 Scope and Definitions.

(a) Scope. (i) The 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) Definition. As used in this part “*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 physical commodity and regularly incurs risks related to such commodity, or is a dealer that regularly provides hedging, risk management or market-making services to the foregoing entities.

### § 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 § 37.5(a), provided the following terms and conditions are met:

- (a)(1) 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 1(a)(3) of the Act.; or  
 (2)(i) 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) Participants that are not eligible participants as defined in § 35.1(b) of this chapter may have trading access only through a registered futures commission merchant that operates in accordance with the provisions of § 1.17(a)(1)(ii) of this chapter;

(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 § 37.3;

(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) If cleared, the submission of such contracts, agreements or transactions for clearance and/or settlement must be to a clearinghouse that is authorized by the Commission under part 39 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 obligations resulting from such agreements; or

(2) arrangements or facilities among parties to such contracts, agreements or transactions, that provide for netting of payments 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 products traded as designated contract markets, or pursuant to parts 36 and 38 of this chapter;

### § 37.3 Conditions for recognition as a derivatives transaction facility

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

(1) Rules relating to trading on its facility, including, depending on the nature of the trading mechanism:

(i) Rules to deter trading abuses, and adequate power and capacity to detect, investigate and take action against violation of its trade rules including arrangements to obtain necessary information to perform the functions in paragraph (a)(1)(i) of this section, or  
 (ii) 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 have occurred;

(2) Rules or terms and conditions defining, or specifications detailing, the operation of the trading mechanism or electronic matching platform;

(3) Rules or terms and conditions detailing the financial framework applying to the transactions or ensuring the financial integrity of transactions entered into by, or through, its facilities; and

(b) Initially, and on a continuing basis, must meet and adhere to the following seven core principles:

(1) Enforcement. Monitor and enforce its rules or terms and conditions including, if applicable, limitations on access.

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

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

(ii) Provide information to the CFTC as requested by the CFTC to satisfy its obligations under the CEA.

(3) Operational information. Disclose to regulators and market participants, to the extent possible, information concerning trading terms, contract terms and conditions, trading mechanisms, financial integrity arrangements or mechanisms, as well as other relevant information.

(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 and, to the extent applicable, information regarding daily opening and closing prices, price range, trading volume and other related market information.

(5) Fitness. As appropriate to the market, have 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.

(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 CFTC 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 CFTC or the U.S. Department of Justice.

(7) Competition. Avoid unreasonable restraints of trade or imposing any burden on competition not necessary or appropriate in furtherance of the objectives of the Act or the regulations thereunder.

#### § 37.4 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 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 by the Commission 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 the derivatives transaction facility's rules and a brief explanation of how the rules satisfy each of the conditions for recognition under § 37.3;

(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 provides guidance to applicants on how the conditions for recognition enumerated in § 37.3 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 delegates, 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.

(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 and 5.3 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. Rules of the derivatives trading facility not submitted pursuant

to § 37.4(b)(3) shall be submitted to the Commission pursuant to § 1.41 of this chapter.

(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 recognition.* A recognized derivatives transaction facility 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.

#### § 37.5 Enforceability

(a) Notwithstanding the exemption in § 37.2, sections 1a, 2(a)(1), 4, 4b, 4c, 4g, 4i, 4o, 5(6), 5(7), the rule disapproval procedures of 5a(a)(12), 5b, 6(a), 6(b), 6(c), 6b, 6c, 8(a), 8(c), 8a(6), 8a(7), 8a(9) 8c(a), 9(a)(2), 9(a)(3), 9(f), 14, 20 and 22 of the Act and §§ 1.3, 1.31, 1.37, 1.41, 5.3, 33.10, Part 5, Part 20, and Part 37 of this chapter continue to apply.

(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.

#### § 37.6 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 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;

(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. Addressing the issues and questions set forth below 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: Monitoring and enforcement of its rules or terms and conditions 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, to: (1) Monitor markets on a routine and non-routine basis as necessary to ensure open and competitive trading and have and, where appropriate, exercise authority to maintain an open and competitive market; or (2) provide information to the Commission as necessary for 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 non-routine 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 large traders only upon Special Call as provided in Part 20 of this chapter.

*Core Principle #3: Operational Information: Disclose to regulators and market participants, to the extent possible, information concerning trading terms, 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, contract terms and conditions, trading mechanisms, financial integrity arrangements or mechanisms. 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, make available to the public with respect to actively traded products and, 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 contracts. 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: 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. 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: Maintenance of 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, 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 United States Department of Justice*

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

*Core Principle #7: Competition: To avoid unreasonable restraints of trade or imposing any burden on competition not necessary or appropriate in furtherance of the objectives of the Act or the regulations thereunder*

Guidance on individual rules, terms or practices is available by submitting a rule for Commission approval under the procedures of § 1.41 of this chapter or by requesting that the Commission issue an Order considering the rule, term or practice under the provision of section 15 of the Act.

11. Chapter I of 17 CFR is proposed to be 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 Conditions for recognition as a recognized futures exchange.

38.4 Procedures for recognition.

38.5 Enforceability.

38.6 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 (a) of this section, the provisions of the exemption in § 38.2 of this part 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) Recognized futures exchanges that have been recognized by the Commission by application under § 38.3 and the products listed for trading thereon 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 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 § 38.5(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 § 38.3;

(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 this part 38;

(c) If cleared, the submission of such contracts, agreements or transactions for clearance and/or settlement must be to a clearinghouse which is authorized by the Commission under part 39 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 obligations resulting from such agreements; or

(2) Arrangements or facilities among parties to such contracts, agreements or transactions, that provide for netting of payments 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 products traded pursuant to parts 36 and 37 of this chapter;

### § 38.3 Conditions for recognition as a recognized futures exchange.

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

(1) 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;

(2) 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;

(3) 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 defined in the operational rules or specifications;

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

(5) 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;

(6) Arrangements to obtain necessary information to perform the above functions, including the capacity and arrangements to carry out the International Information Sharing Agreement and Memorandum of Understanding developed by the Futures Industry Association (FIA) Global Task Force on Financial Integrity, and a mechanism to provide to the public ready access to its rules and regulations; and

(b) Initially, and on a continuing basis, must meet and adhere to the following fifteen core principles:

(1) Rule enforcement. Monitor and enforce its rules;

(2) Products. List contracts for trading which are not readily susceptible to manipulation;

(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;

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

(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;

(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;

(7) Transparency. Provide, appropriate to the market, information to the public regarding prices, bids and offers, including the opening and closing prices and daily range, and information on volume and open interest;

(8) Trading system. Provide a competitive, open, and efficient market;

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

(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, have rules addressing the financial integrity of the intermediary and the protection of customer funds as appropriate and a program to enforce those requirements;

(11) Customer protection. Have, monitor and enforce rules for customer protection;

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

(13) Governance. Have fitness standards for members, for 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;

(14) Recordkeeping. Keep full books and records of all activities related to their business as a recognized futures exchange in a form and manner acceptable to the CFTC 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 CFTC or the U.S. Department of Justice; and

(15) Competition. Avoid unreasonable restraints of trade or impose any burden on competition not necessary or appropriate in furtherance of the objectives of the Act or the regulations thereunder.

#### § 38.4 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 the effective date of this rule in at least one commodity which is not dormant within the meaning of § 5.2 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 by the Commission 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 a brief explanation of how the rules satisfy each of the conditions for recognition under § 38.3;

(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 provides guidance to applicants on how the conditions for recognition enumerated in § 38.3 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 delegates, 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.

(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 5.3 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 § 38.4(b)(3) shall be submitted to the Commission pursuant to § 1.41 of this chapter.

(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.

#### § 38.5 Enforceability

(a) Notwithstanding the exemption in § 38.2, sections 1a, 2(a)(1), 4, 4a, 4b, 4c, 4g, 4i, 4o, 5(6), 5(7), the rule disapproval procedures of 5a(a)(12), 5b, 6(a), 6(b), 6(c), 6b, 6c, 8(a), 8(c), 8a(6), 8a(7), 8a(9), 8c(a), 8c(b), 8c(c), 8c(d), 9(a), 9(f), 20 and 22 of the Act and §§ 1.3, 1.31, 1.37, 1.38, 1.41, 33.10, part 5, part 9, parts 15–21 and part 38 of this chapter continue to apply.

(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.

### § 38.6 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

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 is offered under subsection (a) following a Core Principle. Addressing the issues and questions set forth therein 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. 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 below will meet the applicable Core Principle. Except where otherwise provided, subsection (b) does not state the exclusive means for satisfying a Core Principle.

#### Core Principle #1: Rule Enforcement: 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 these 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 which are not readily susceptible to manipulation

(a) *Application Guidance.* Applicants should submit their initial product for listing for Commission approval under § 5.1 and Part 5, Appendix A of this chapter. Subsequent products may be listed for trading by self-certification under § 5.3 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 a 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 markets 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.* [Reserved].

(b) *Acceptable Practices.* A recognized futures exchange should have clear procedures and guidelines for exchange decision-making regarding emergency intervention in the market. 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. 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. 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 for documentation of the exchange's decision-making process and the reasons for use of its emergency action authority.

*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, appropriate to the market, information to the public regarding prices, bids and offers, including the opening and closing prices and daily range, and information on volume and open interest*

(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 an independent third party. A professional that is a certified member of the Informational Systems Audit and Control Association experienced in the industry would be an acceptable party to carry out such testing and review. 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.* [Reserved].

*Core Principle #9: Audit trail: Have in place procedures to ensure the recording of full data entry and trade details sufficient to reconstruct trading, the safe storage of such information and systems to enable information to be used in assisting in combating customer and market abuse. Such procedures should ensure the quality of data captured*

(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) *Electronic 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, have 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 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 financial and related information. Rules addressing the protection of customer funds should address the segregation of customer and proprietary funds, the custody of customer funds and the investment standards for customer funds.

(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, as provided in § 166.5 of this part. 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.

(4) A counterclaim which arises out of a transaction or occurrence that is the subject of a customer's claim or grievance and which does not require for adjudication the presence of essential witnesses, parties or third persons over whom the recognized futures exchanges does not have jurisdiction could be allowed under the recognized futures exchange's dispute resolution procedures. Other counterclaims should be permissible only if the customer agreed to the submission after the counterclaim had arisen, and if the aggregate monetary value of the counterclaim was capable of calculation.

(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, for 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.* 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. The standards could be based on the disqualification standards under section 8a(2) of the Act. 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.

(b) *Acceptable Practices.* [Reserved]

*Core Principle #14: Recordkeeping: Must keep full books and records of all activities related to their 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 United States 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: Recognized futures exchanges should avoid unreasonable restraints of trade or impose any burden on competition not necessary or appropriate in furtherance of the objectives of the Act or the regulations thereunder*

(a) *Application Guidance.* A recognized futures exchange should avoid unreasonable restraints of trade in any terms and conditions of access or provision of services or any non-compete clauses or limitations on future activity.

(b) *Acceptable Practices.* [Reserved]

## **PART 100—[REMOVED AND RESERVED]**

12. Part 100 is proposed to be removed and reserved.

## **PART 170—REGISTERED FUTURES ASSOCIATIONS**

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

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

14. Section 170.8 is proposed to be 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 [REMOVED]**

15. Part 180 is proposed to be removed.

Issued in Washington, DC, this 8th day of June, 2000, by the Commission.

**Jean A. Webb,**

*Secretary of the Commission.*

[FR Doc. 00-14914 Filed 6-21-00; 8:45 am]

**BILLING CODE 6351-01-P**

## **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:** Proposed rules.

**SUMMARY:** On February 22, 2000, a staff task force of the Commodity Futures Trading Commission ("CFTC" or "Commission") submitted a report to the CFTC's Congressional oversight committees entitled A New Regulatory Framework. To further the regulatory reform process, the Commission is proposing to revise its rules relating to intermediation of commodity futures and commodity options ("commodity interest") transactions.

The proposed new rules would provide greater flexibility in several areas. To ease barriers to entry for persons seeking registration as futures commission merchants ("FCMs") or introducing brokers ("IBs"), the Commission would: Provide a simplified registration procedure for those persons wishing to operate as FCMs or IBs only on recognized derivatives transaction facilities "DTFs" for institutional customers, and who are regulated by other federal financial regulatory agencies; and eliminate the requirement to submit a certified financial report as part of the standard registration application for FCMs and IBs. For all registrants, the Commission would eliminate its rule requiring ethics training, replacing it with a Statement of Acceptable Practices. In addition, the Commission would respond favorably to a rule change of the National Futures Association ("NFA") that would relieve sales personnel dealing only with institutional customers of the requirement to pass a proficiency test. The Commission is also proposing to amend the definition of the term "principal" in Rule 3.1(a), mainly to eliminate inclusion of certain types of officers of a firm, and to make conforming amendments to other rules.

Account opening procedures would be simplified to allow for all required disclosures (with the exception of arbitration agreements) to be acknowledged with a single signature, which may be an electronic signature. The obligation for FCMs and IBs to provide a specific disclosure statement would also be eliminated for a greater number of sophisticated customers. Electronic transmission of account

statements would also be permitted, and the Commission's rules as to close-out of offsetting positions would be streamlined to allow for customer choice.

Further, the Commission proposes to expand the range of instruments in which FCMs may invest customer funds. The Commission also requests comment concerning whether customers should be allowed to "opt out" of the rules requiring segregation of customer funds, and whether FCMs should be allowed to maintain, in the same customer segregated account, funds used for the purpose of securing or margining instruments other than those currently permitted. Finally, the Commission is considering the issuance of a separate order revising its previous pronouncements regarding the treatment of customer funds on deposit with FCMs for the purpose of trading on foreign markets.

**DATES:** Comments must be received on or before August 7, 2000.

**ADDRESSES:** Comments on the proposed rules should be sent to Jean A. Webb, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581. Comments may be sent by facsimile transmission to (202) 418-5521, or by e-mail to [secretary@cftc.gov](mailto:secretary@cftc.gov). Reference should be made to "Proposed Rules Concerning Intermediaries."

**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 Andrew J. Shipe, 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.

### **SUPPLEMENTARY INFORMATION:**

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## I. Introduction

As announced elsewhere in this edition of the **Federal Register**, the Commission has proposed a new regulatory structure that is intended to adapt to the changing needs of the modern marketplace. In reviewing its regulatory structure, the Commission has identified eight Core Principles that it believes are fundamental to assuring proper conduct by intermediaries of commodity interest transactions. While the Commission is not proposing to adopt these Core Principles as rules, they have guided the Commission in its regulatory reform efforts. The Commission has reviewed all of its rules related to intermediaries in light of the Core Principles. To the extent that an existing rule is not discussed herein, and no amendment thereto is being proposed, the rule would apply to intermediaries transacting business on behalf of customers on contract markets, recognized futures exchanges ("RFEs") and DTFs.

In accordance with these Core Principles, the Commission now proposes 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.<sup>1-3</sup> While the Commission, in this release, is announcing certain proposed changes in its regulatory structure that would be applicable to all categories of Commission registrants (e.g., the principal definition and ethics

<sup>1-3</sup> As noted elsewhere in this edition of the **Federal Register**, the Commission is proposing a new market structure, an exempt multilateral transaction execution facility ("MTEF"), wholly exempt from Commission regulation, except for the antifraud and antimanipulation provisions of the Commodity Exchange Act ("Act"). Intermediaries would generally not be subject to regulation as to their activities on such an exempt MTEF. Accordingly, the proposals discussed in this release are applicable generally only to intermediaries on RFEs, DTFs and contract markets. It should also be noted that some DTFs may permit trading only on a principal-to-principal basis. Since the rule amendments proposed herein relate only to intermediaries, they would not be applicable to such a market structure.

training requirements discussed below), the Commission is aware that certain proposals would mainly affect FCMs and IBs, and would not be applicable to commodity pool operators ("CPOs") and commodity trading advisors ("CTAs"). Nevertheless, the Commission seeks comment on these proposals from all categories of Commission registrant.

The Commission also 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.<sup>4</sup> Similarly, the Commission is considering various changes to the capital requirements for FCMs, including a risk-based approach.

The Commission also intends to consider further rulemaking proposals at a subsequent date that may focus more directly upon Part 4 of the Commission's rules, which govern the activities of CPOs and CTAs. As examples of its reform efforts with regard to such persons, the Commission has recently proposed to bring more persons within the definition of a "qualified eligible client" of a CTA or a "qualified eligible participant" of a commodity pool, see 65 FR 11253 (March 2, 2000), which would lessen the disclosure, recordkeeping and reporting requirements for CTAs and CPOs, and to permit CTAs to compute the rate of return for partially funded accounts (also known as "notionally funded accounts") by dividing net performance by the agreed-upon nominal account size, see 64 FR 41843 (Aug. 2, 1999).

Industry representatives have indicated that they would prefer uniform standards for intermediaries dealing with institutional customers without regard to the type of facility on which a trade is executed. Many of the proposals contained herein would have that effect. The Commission requests comment on whether there are other specific requirements that should be modified toward that end.

The Core Principles 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, CPO, 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 MTEF 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 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, 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 and maintain 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 would be required on a routine and nonroutine basis as is the case for transactions on contract markets. Reports of transactions on DTFs would be required only on a non-routine basis.

### 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

<sup>4</sup> See Interpretative No. 4-2, CFTC Staff Letter 99-32, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶27,745 (August 20, 1999).

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.

## II. Proposed Rules

### A. Core Principle One: Registration

#### 1. Definition of the Term "Principal"

The second proviso to Section 8a(2) of the Act states that a principal shall mean a general partner of a partnership, any officer, director or beneficial owner of at least ten percent of the voting shares of a corporation, "and any other person that the Commission by rule, regulation or order determines has the power, directly or indirectly, through agreement or otherwise, to exercise a controlling influence over the activities of [a firm] which are subject to regulation by the Commission."

The Commission has implemented this statutory provision by adopting a definition of "principal" in its registration rules that includes certain specified persons, such as corporate officers and directors, as well as persons who have the power "directly or indirectly, through agreement or otherwise, to exercise a controlling influence" over the activities of a firm.<sup>5</sup> The identification of an applicant's or registrant's principals is crucial to enabling the Commission or the National Futures Association ("NFA"), which performs various registration functions for the Commission pursuant to delegations of authority, to perform a fitness assessment under the Act. It also provides information about individuals and firms who provide commodity interest services to market participants. Because of the important role principals play in the Commission's regulatory structure, CFTC rules impose various listing, disclosure, and recordkeeping

<sup>5</sup> 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 commodity pool operators ("CPOs") and commodity trading advisors ("CTAs"). The rules are substantially equivalent, although Rule 3.1(a)(1) contains the final clause "to exercise a controlling influence over its activities which are subject to regulation by the Commission" while Rule 4.10(e)(1)(i) concludes "to exercise a controlling influence over the activities of the entity." This distinction has not been significant in the Commission's analysis of whether a given person is a principal. The Commission nevertheless proposes to conform these definitions, as detailed herein, to remove any possible ambiguity.

requirements on a registrant with regard to its principals.<sup>6</sup>

The Commission staff's current interpretation of Rules 3.1(a)(1) and 4.10(e)(1)(i) is to treat all officers and directors of a registrant as principals, pursuant to the language of the second proviso to Section 8a(2) of the Act.<sup>7</sup> The Commission recognizes, however, that there have been changes in management structures over the last 20 years. The Commission further notes that it has received 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. While the Commission believes that, under its rules, certain officers should continue to be listed as principals, it also recognizes that listing may be unnecessary for some mid-level officers. The Commission therefore believes it appropriate to amend its rules so that not all of a registrant's officers will be considered to be principals, while ensuring that appropriate personnel remain listed as such.

The Commission proposes to amend Rule 3.1(a)(1) by defining as principals persons within a given organizational structure who hold specific offices. Thus, the principal definition would include, if the entity is organized as a sole proprietorship, the proprietor; if a partnership, any general partner (including individuals and entities,

<sup>6</sup> See, e.g., CFTC Rule 3.10(a)(2) (principals must complete a Form 8-R and submit a fingerprint card); Rules 4.24(e)(1), 4.24(f)(1)(v) and 4.24(j)(1)(v), applicable to CPOs, and 4.34(e)(1), 4.34(f)(1)(ii), and 4.34(j)(1)(iv), applicable to CTAs (identity of principals, business background of those principals who participate in making trading or operational decisions or supervise persons so engaged, and information about any conflicts of interest regarding principals must be disclosed in the Disclosure Document); Rules 4.23(b)(2)(ii) and 4.33(b)(2)(ii), applicable to CPOs and CTAs, respectively (recordkeeping requirements for transactions of principals); Rules 4.25(a)(8)(ii)(A), 4.25(b)(2), 4.25(c)(2)(i)(B), 4.25(c)(2)(ii), applicable to CPOs, and Rules 4.35(a)(7)(ii)(A) and 4.35(b), applicable to CTAs (disclosure requirements for performance of accounts or pools owned or controlled by principals).

<sup>7</sup> See, e.g., CFTC Staff Letter No. 76-15, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,194 (Office of General Counsel, Aug. 2, 1976) (the term "individual principals" includes officers, directors, principal shareholders and any other person who, directly or indirectly, controls the CTA); CFTC Staff Letter No. 95-19, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,346 (Division of Trading and Markets, Feb. 24, 1995) (CTA required to list corporate secretary as a principal despite contention that her duties were clerical); CFTC Staff Letter No. 98-29, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,312 (Division of Trading and Markets, Apr. 1, 1998) (CTA required to list sixteen employees who were either vice presidents, senior vice presidents or executive vice presidents as principals).

such as corporations); if a corporation, any director, the president, chief executive officer, chief operating officer, chief financial officer.<sup>8</sup> and any person in charge of a principal business unit, division or function subject to regulation by the Commission; and, 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 management authority for the entity, and any person in charge of a principal business unit, division or function subject to regulation by the Commission. Thus, a registrant would no longer automatically be required to treat every officer as a principal, but only those who met the criteria of the rule.

The principal definition would also include an individual who directly or indirectly, through agreement, holding company, nominee, trust or otherwise: (1) Is the owner of ten percent or more of any class of a firm's securities; (2) is entitled to vote ten percent or more of any class of a firm's voting securities; (3) has the power to sell or direct the sale of ten percent or more of any class of a firm's voting securities; (4) has contributed ten percent or more of a firm's capital (excluding unaffiliated banks and insurance companies); or (5) is entitled to receive ten percent or more of a firm's profits. Further, the principal definition would include an *entity* that is the direct owner of ten percent or more of any class of a firm's securities or that has directly contributed ten percent or more of a firm's capital.<sup>9</sup> These proposed amendments would permit the deletion of Rule 3.10(a)(2)(ii), which has proved somewhat unwieldy in practice.<sup>10</sup>

Finally, the principal definition would continue to include the general provision that defines as a principal any person occupying a similar status or performing similar functions, having the

<sup>8</sup> As an indication of the importance of the chief financial officer, the Commission notes that for purposes of filing a Notice of Claim of Exemption ("Notice") under Rules 4.7, 4.12 or 4.13, if the registrant is organized as a corporation, the rules provide that the chief financial officer may sign the Notice. The Commission also notes that the attestation to the truth and correctness of information contained in a financial report can be made by a chief financial officer. Rule 1.10(d)(4) (applicable to FCMs and IBs).

<sup>9</sup> The portion of the principal definition concerning contribution of capital retains the current provisions of Rule 3.1(a)(3), which does not appear in this release because it is not being amended.

<sup>10</sup> The proposed amendments would also result in the redesignation of Rule 3.10(a)(2)(i) as Rule 3.10(a)(2) and conforming modifications to Rule 3.32(a)(2).

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.<sup>11</sup>

The Commission also proposes to amend Rule 3.1(a) to conform it with certain provisions of Rule 3.32, which governs re-registration and specifies certain events or changes within a firm's management that require a new registration. Absent this proposed amendment, the interplay of Rule 3.32 and Rule 3.1 could create an anomaly when, for example, under Rule 3.1, a firm would not be required to list a person as a principal, but under Rule 3.32 would be required, because of that person, to obtain a new registration.

Thus, to conform to Rule 3.1(a)(1), paragraph (a)(1)(v) of Rule 3.32, addressing corporate registrants, would be amended to include any person who becomes "the president, chief executive officer, chief operating officer or chief financial officer of a corporate registrant, or becomes in charge of a principal business unit, division or function subject to regulation by the Commission, or comes to occupy a position of similar status or perform a similar function." Similarly, with respect to limited liability companies and limited liability partnerships, a new paragraph (a)(1)(vi) would be added so that re-registration would also be required when there is a new person who becomes "a director, president, chief executive officer, chief operating officer, chief financial officer, manager, managing member or member vested with management authority for the registrant, or \* \* \* in charge of a principal business unit, division or function subject to regulation by the Commission, or comes to occupy a position of similar status or perform a similar function."<sup>12</sup> In line with new paragraph (a)(1)(vi) of Rule 3.32, which brings within the ambit of the rule changes affecting the management of a limited liability company or limited liability partnership, Rule 3.32(a)(1)(i) would be amended to delete the word "corporate" before "registrant's voting securities" so as to permit a broader application of that paragraph to registrants other than corporate registrants. To conform Rule

3.32(a)(1)(v) and (a)(1)(vi) to Rule 3.32(e)(1), the latter would be amended by adding a reference to the former.<sup>13</sup>

In addition, the Commission proposes to amend Rule 4.10(e)(1) to incorporate by reference the definition of "principal" in amended Rule 3.1(a).<sup>14</sup> Finally, the Commission proposes to amend 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, to conform these rules to proposed Rule 3.1(a)(1), as incorporated by reference in amended Rule 4.10(e)(1). Thus, a registrant would 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.

The Commission's intent in proposing these amendments is to provide a uniform definition and treatment of principals under its rules. The amendments would require the filing of fewer individual registration forms (Forms 8-R) and fingerprint cards, and would also require less disclosure by CPOs and CTAs. The Commission does not intend to alter the application of any other CFTC rule that provides relief from registration requirements. For example, the exemption from registration as an associated person ("AP") that is available to the chief operating officer, general partner or other person in the supervisory chain-

<sup>13</sup> Re-registration can be avoided by following the procedures in paragraph (e)(1) of Rule 3.32, which require a registrant to file a Form 3-R to amend its Form 7-R, and to include a Form 8-R and fingerprint card for the new officer, manager or member, unless a current Form 8-R is already on file for that person. These documents must be submitted to the NFA prior to the date of the change in personnel, which is not considered effective until the NFA provides the registrant with written approval. Therefore, some advance planning by registrants should make this a relatively straightforward process.

<sup>14</sup> Although Rule 4.10(e) was amended in 1981 to conform more closely to the wording of Rule 3.1(a)(1)-(a)(3), the terminology in the Rules remained slightly different. When Rule 4.10(e)(1) was adopted, the Commission explained that "[b]ecause the term 'principal' is employed in both Part 3 and Part 4 to obtain similar critical information about certain persons associated with a CPO or a CTA, the Commission has determined to use the same term in both parts. To serve the objectives of Part 4, however, the term 'principal' does not need to be defined as broadly as it is in § 3.1(a)." 46 FR 26004, 26005 (May 8, 1981). Because the amendments to Rule 3.1(a) proposed herein will restrict the definition of principal so that, for example, not all officers of a corporate registrant will be included, the Commission believes it is no longer appropriate to have different definitions of the term "principal" in Parts 3 and 4.

of-command of a registrant under Rule 3.12(h)(1)(iii) would remain intact.<sup>15</sup>

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

As reflected in the Core Principles, intermediaries and FTs in all CFTC recognized markets, absent an exemption, are and will be required to be registered with the CFTC under the Act. Registration requirements, however, could be eased in several ways, depending on the particular markets on which the intermediary transacts business.

Under the proposed rules, persons who intermediate transactions on or subject to the rules of an RFE must be registered under the Act as FCMs, IBs, CPOs, CTAs, APs of any of the foregoing, or FBs, or qualify for an existing statutory or regulatory exemption from registration.<sup>16</sup> If such persons are required to register as FCMs, they must also become and remain a member of a registered futures association.<sup>17</sup> In addition, persons who trade for their own account on the floor of an exchange must register as FTs.

Persons whose business is limited exclusively to transactions conducted on or subject to the rules of a DTF also would be required to register as FCMs, IBs, CPOs, CTAs, FBs or FTs, if they perform those functions. Registration as an FCM or IB, however, would be simplified for persons that conduct business solely for institutional customers<sup>18</sup> on a DTF, if they were already registered with the Securities and Exchange Commission ("SEC") in a similar registration category or they were authorized to perform these functions by a federal banking authority. Under the proposed changes to Rule 3.10, such applicants would be

<sup>15</sup> That rule provides an exemption from AP registration for certain principals provided that, among other requirements, the sponsoring firm's revenue from commodity interest related activity for customers is no more than ten percent of its total revenue on an annual basis.

<sup>16</sup> See, e.g., Section 4m(1) of the Act, Commission Rules 3.10(c), 4.13 and 4.14.

<sup>17</sup> Commission Rule 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.

<sup>18</sup> The Commission proposes a definition of the term "institutional customer" in Rule 1.3(g), which would be the same as the definition of "eligible participant" in Rule 35.1(b) that is set forth in one of the Commission's other **Federal Register** notices published today.

<sup>11</sup> While the Commission recognizes that what constitutes "a controlling influence" is best left for determination on a case-by-case basis, such influence would be ascribed to, among others, those persons who have policymaking or managerial authority over the activities of an applicant or registrant that are subject to Commission regulation.

<sup>12</sup> The existing paragraphs (a)(1)(vi) and (a)(1)(vii) of Rule 3.32 would be redesignated as paragraphs (a)(1)(vii) and (a)(1)(viii), respectively.

registered in the corresponding CFTC registration category (FCM or IB) upon filing notice with the 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.<sup>19</sup> This would avoid the need to file CFTC registration forms and fingerprints. A firm acting in the capacity of an FCM would, however, be required to become a member of a registered futures association.<sup>20</sup> Because it would be difficult to track individual sales personnel of these firms without registration forms, individuals acting in the capacity of APs for such FCMs or IBs would not be required to be registered or listed, and would not be subject to proficiency testing or ethics training requirements. Finally, such firms and their salespersons would, of course, remain subject to antifraud provisions.

The Commission believes that this proposed structure is appropriate because (i) firms and individuals involved would be permitted to deal only with institutional customers, (ii) they would be subject to oversight by other federal regulatory authorities, and (iii) the Commission anticipates that they will conduct most of their business in the securities or banking fields, with only a minor portion of their activities involving commodity interests. Nevertheless, the Commission wishes to stress that its reform efforts are an ongoing process, and that it seeks comment on all facets of the proposal.

In order to implement these changes, the text of Rule 3.10 would be revised by redesignating paragraph (a)(1)(i) as (a)(1)(i)(A), and a new paragraph (a)(1)(i)(B) would be added. The new paragraph would provide that an applicant for registration as an FCM or IB that will conduct transactions exclusively on or subject to the rules of a DTF for institutional customers, and who is registered with the SEC 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 NFA notice of its intention to undertake transactions exclusively on or subject to the rules of

a DTF 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.

Further, paragraph (d) of Rule 3.10 is proposed to be amended by replacing the existing cross-reference to "paragraph (a)" with a conforming cross-reference to "paragraph (a)(1)(i)(A)" so that those registrants who choose to follow these newly proposed registration procedures will not be required to file an annual update of the basic registration form for firms, Form 7-R.

The Commission also proposes not to require such "passported" registrants to meet the Commission's minimum financial requirements if (i) they meet the appropriate net capital requirements of their primary regulator, (ii) their activities are limited to serving institutional customers trading exclusively on DTFs that do not require compliance with CFTC minimum financial requirements, and (iii) they conform to minimum financial standards and related reporting requirements set by such DTF in its bylaws, rules, regulations or resolutions.<sup>21</sup> In this regard the Commission seeks comment on the propriety of such reforms.

The Commission is therefore proposing to add a new paragraph (iii) to Rule 1.17(a)(2), which currently contains two exemptions from the Rule's adjusted net capital requirements. The new paragraph would provide that the basic minimum financial requirements would not apply to an FCM registered under the new "passporting" procedures in proposed Rule 3.10(a)(1)(i)(B) whose business is limited to transacting business on behalf of institutional customers on a DTF, and who conforms to minimum financial standards and related reporting requirements set by such DTF in its bylaws, rules, regulations or resolutions. A conforming amendment would be added to Rule 1.52 by adding a new paragraph (m) to relieve a DTF from the requirement that it adopt minimum adjusted net capital standards that are modeled on those of the Commission

with respect to these "passported" firms.

The Commission notes that as it proposes to simplify the registration process for SEC registrants that may wish to conduct the limited activities in futures markets described above, it encourages 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.

Finally, the Commission is considering updating and making more flexible its standard minimum net capital requirements with respect to FCMs by permitting the application of risk-based net capital requirements. At this time, the Commission is not proposing changes to its requirements in this area. Rather, the Commission wishes to solicit input from commenters regarding the most effective approach to developing changes to these rules.

### 3. Standard Application Procedures for FCMs and IBs

In order to lower a potential barrier to entry for new firms and to conform CFTC practice more closely with that of the SEC, the Commission proposes to streamline further its current application requirements for the registration of FCMs and IBs. Current Commission Rules 3.10(a)(1)(ii) and 1.10(a)(2) require new applicants for registration as FCMs and IBs to file Form 1-FR-FCM or 1-FR-IB, respectively, with their applications. Pursuant to Rule 1.10(a)(2), these forms must be certified by an independent public accountant.

The Commission is proposing that applicants for registration as FCMs or IBs who raise their own capital to satisfy minimum financial requirements would not be required to provide these certified financial statements with their registration applications.<sup>22</sup> Rather, such applicants would be permitted to file an unaudited financial report indicating satisfaction of the minimum requirements. A firm taking advantage of this 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. This alternative procedure is modeled on similar procedures in the securities industry. An applicant would remain

<sup>19</sup> The Commission will, naturally, consult with other agencies to solicit their views and determine the most appropriate method of effecting this proposal.

<sup>20</sup> See Rule 170.15. 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.

<sup>21</sup> Intermediaries engaged in transactions on DTFs that are not registered or licensed by another regulator would be subject to the CFTC's minimum financial requirements, even if all of the transactions they are involved in occur on or subject to the rules of a DTF. It should also be noted that these rule amendments relate only to intermediaries, and are thus inapplicable to persons who participate in transactions on DTFs solely on a principal-to-principal basis in accordance with DTF rules.

<sup>22</sup> Those IB applicants who do not raise their own capital would continue to be required to file a guarantee agreement entered into with an FCM with their registration application.

free to follow the existing rules concerning the filing of a certified financial statement with its application and thereby delay the initial DSRO review.<sup>23</sup> Appropriate rule changes would be made by adding new paragraphs (a)(2)(i)(C) and (a)(2)(ii)(D) to Rule 1.10.

### *B. Core Principles Two and Six: Fitness and Supervision*

#### 1. Proficiency Testing and Ethics Training for Individual Registrants

The second of the Core Principles for intermediaries identified by the Commission is that intermediaries in commodity interest markets must be and remain fit. This requirement is reflected by various provisions of the Act. Section 4p(a) of the Act permits the Commission to require written proficiency examinations for individual applicants for registration. Section 17(p) of the Act further requires that any futures association registered under the Act must submit to the Commission for approval rules to establish training standards and proficiency testing for persons involved in solicitations of transactions, their supervisors and all persons for whom the association has registration responsibilities. The NFA administers this testing program through the facilities of the National Association of Securities Dealers, Inc. NFA rules that the Commission has approved generally require that all applicants for AP registration present evidence of passage of a proficiency test, the basic test being the National Commodity Futures Examination (commonly known as the "Series 3 Test"). In keeping with the recommendations of A New Regulatory Framework, the Commission believes that those APs dealing only with institutional customers need not pass a specific proficiency examination, and it would consider an NFA rule change to this effect. The Commission notes that under Sections 4p(a) and 17(p) of the Act and Rule 170.10, NFA is currently allowed to adopt such rules as it may deem appropriate, subject to Commission approval. Therefore, no changes to the Commission's rules are deemed necessary to effect these changes.

Section 4p(b) of the Act requires the Commission to issue regulations requiring new registrants to attend ethics training sessions within six months of registration, and requiring all registrants to attend such training on a periodic basis. The Commission has

issued Rule 3.34 to fulfill this statutory mandate. Rule 3.34 specifies the frequency and duration of such training, the suggested curriculum, qualifications of instructors, and the necessary proof of attendance at such classes.

In order to provide flexibility and ease compliance for all registrants, the Commission proposes to delete Rule 3.34. In place of that rule, the Commission proposes to implement Congressional intent through a Statement of Acceptable Practices consistent with its second Core Principle, which requires intermediaries to be and remain fit. The Commission believes that the maintenance of professional ethical standards is a key element of a registrant's fitness. Further, training standards in the field of ethics are relevant to adherence to the sixth Core Principle, requiring adequate supervision of handling accounts by a firm and its personnel. The Commission therefore proposes to issue this Statement of Acceptable Practices as an Appendix to Part 3 of its Rules. The Commission believes that Section 4p(b) of the Act expresses Congressional intent that futures industry professionals remain abreast of their responsibilities to the public under the Act and rules thereunder. The Commission further believes that there can be greater flexibility concerning acceptable practices to achieve this objective than is permitted under the existing rule. For registrants seeking guidance as to the maintenance of proper ethics training procedures in keeping with the purposes of the Core Principles, the Statement of Acceptable Practices would function as a "safe harbor."

For instance, under the Statement of Acceptable Practices, registrants may engage in ethics training programs sponsored by the registrants themselves, their DSROs, trade associations or others. The format of such training, whether by personal or recorded instruction, or by circulation of written materials such as legal cases, interpretative letters or advisories, would also be left to the discretion of registrants and DSROs. It would also be permissible to require training on whatever periodic basis the registrant and DSROs deem appropriate. Thus, the Commission would not specify any particular programs or procedures that must be followed.

#### 2. Reforms Relating to Statutory Disqualification From Registration

The grounds for statutory disqualification from registration, which establish fitness standards based upon disciplinary history, are set forth in

Sections 8a(2) and (3) of the Act. One of those provisions states that registration can be denied or conditioned based upon, in addition to specific matters such as revocation of a previous registration or a felony conviction, "other good cause" (see Section 8a(3)(M) of the Act). In an effort to provide greater clarity in this area, the Commission recently revised the "Guidance Letter" issued to NFA concerning the treatment of self-regulatory organization ("SRO") disciplinary actions in assessing the fitness of FBs, FTs or applicants in either category. See CFTC Letter No. 00-56 (April 13, 2000); *CFTC Guidance to NFA Concerning Floor Broker and Floor Trader Registration Actions*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. ¶ 27,202 (Dec. 4, 1997). The Commission considers these letters to be part of its overall regulatory reform efforts and intends to publish both as an accompanying statement when it publishes final rules. The Commission requests comment as to any further changes that should be considered in this area.

### *C. Core Principal Three: Financial Requirements*

#### 1. Trading by Non-Institutional Customers on DTFs

As noted above, the Commission's proposed new regulatory framework contemplates the recognition of a new form of trading facility that is subject to an intermediate degree of regulatory oversight, the DTF. Under the proposed rules, trading on DTFs generally would be limited to futures and options on specified commodities. In addition, DTFs could permit trading on any commodities if trading is limited to qualifying commercial participants.

Thus, although trading on DTFs would generally be limited to institutional or commercial customers, under certain conditions a DTF might permit non-institutional customers to enter into transactions thereon. Because of the lower regulatory protections offered to participants in these markets, and the higher degree of risk associated therewith, the Commission is proposing that such non-institutional customers' business be transacted through FCMs that are more capable of properly maintaining such accounts and handling the associated risk. This is in accordance with the third Core Principle, which requires intermediaries to maintain adequate capital to ensure they are able to meet their obligations to customers. Thus, non-institutional customers who desire to conduct transactions on or subject to the rules of

<sup>23</sup> Of course, a DSRO retains the authority to inspect its member firms at any time.

a DTF would be required to do so 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 (the basic minimum requirement for FCMs is \$250,000). The Commission notes that this would not prevent a DTF from including any similar or greater restrictions in its own rules or bylaws. Further, in order to provide guidance to such customers and their FCMs, NFA will issue a Statement of Acceptable Practices regarding additional disclosures to be made to non-institutional customers trading on DTFs and on related issues involving price dissemination. The Commission presumes that this would be forthcoming as DTFs come into existence. Since DTFs do not yet exist, and it is not known how such institutions would choose to operate, the Commission believes that it is premature at this time to propose a Statement of Acceptable Practices in this area.

Therefore, the Commission proposes to amend Rule 1.17, to add a new paragraph (a)(1)(ii) and to redesignate current paragraph (a)(1)(ii) as (a)(1)(iii). The new paragraph (a)(1)(ii) would provide that an FCM engaged in soliciting or accepting orders and customer funds related thereto from a non-institutional customer for the purchase or sale of any commodity for future delivery on or subject to the rules of a DTF must be a clearing member of a contract market or an RFE and must maintain adjusted net capital at least equal to the greater of \$20 million or the other amounts specified in Rule 1.17.

## 2. Segregation of Funds

The futures industry has a long history of keeping customer funds safe. The Commission believes that segregation of customer funds has worked well and should continue to be required for the funds of all customers trading on an RFE and the funds of all non-institutional customers trading on a DTF that permits such customers. Nevertheless, the Commission is considering whether, and under what circumstances, to permit other customers to "opt out" of segregation. Before proposing any rule changes in this area, however, the Commission seeks comment as to how, if at all, this change should be implemented. Commenters may wish to address several issues in this area, including:

- Whether opting out of segregation should be permitted;
- If so, whether it should be limited to the accounts of institutional customers;

- Where such non-segregated funds should be held;
- How such funds would be accounted for, especially for purposes of establishing minimum capital requirements, and computing a firm's adjusted net capital;
- How accounts that have opted out of segregation would be treated under Part 190 of the Commission's rules, and under the Bankruptcy Code;
- What the effects of similar practices have been in other jurisdictions; and
- What an FCM's disclosure obligations should be in this area.

The Commission notes that certain industry participants have also suggested that the Commission revise its regulations to permit 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. The Commission notes that, pursuant to its authority under the second proviso of Section 4d(2) of the Act,<sup>24</sup> it has previously permitted futures and securities options to be held in the same customer segregated account pursuant to cross-margining arrangements.<sup>25</sup> The Commission believes that, under Section 4d(2) of the Act, the segregation requirements could be modified to permit such additional instruments and funds to be held in a single segregated account at both the FCM and the clearing organization level. As with the concept of "opting out" of segregation, the Commission believes, however, that further consideration is necessary in this area before a formal proposal can be made. Therefore, the Commission seeks comment as to how such changes might be implemented. Commenters may wish to address several issues in this area, including:

- What protections would be necessary in order to permit FCMs and clearing organizations to maintain, in the same customer segregated account, additional instruments and products and the funds used for the purpose of securing or margining such instruments and products;

<sup>24</sup> 7 U.S.C. 6d(2) (1994).

<sup>25</sup> See, e.g., Commission Order, In the Matter of the Chicago Mercantile Exchange Proposal to Expand its Cross-Margining Program with the Options Clearing Corporation to Include the Cross-Exchange Net Margining of the Positions of Market Professionals, (November 26, 1991), reprinted in 56 FR 61404 (December 3, 1991); Commission Order, In the Matter of The Intermarket Clearing Corporation Proposal to Expand its Cross-Margining Program with the Options Clearing Corporation to Include the Cross-Exchange Net Margining of the Positions of Market Professionals (November 26, 1991), reprinted in 56 FR 61406 (December 3, 1991). For each of these programs, the SEC approved parallel rules of the Options Clearing Corporation.

- Whether such practices should be limited to the accounts of institutional customers;
- Whether, if this is permitted, it would be desirable to permit "opting out" of segregation;
- How such funds would be accounted for, especially for purposes of establishing minimum capital requirements and computing a firm's adjusted net capital;
- How such accounts would be treated under Part 190 of the Commission's Rules, and under the Bankruptcy Code;
- What the effects of similar practices have been in other jurisdictions; and
- What an FCM's disclosure obligations should be in this area.

## 3. Investment of Customer Funds

The Commission also is proposing to amend Rule 1.25, which sets forth the types of instruments in which FCMs and clearing organizations are permitted to invest (the permitted investments) cash segregated for the benefit of regulated commodity customers pursuant to Section 4d(2) of the Act. Currently, Rule 1.25 permits an FCM or clearing organization 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 believes that an expanded list of permitted investments could enhance the yield available to FCMs, clearing organizations and their customers, without compromising the safety of customer funds.

Subject to specific risk-limiting features contained in the proposal, the following additional investments would be permitted: (1) Obligations issued by any agency sponsored by the United States; (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. In addition, it is proposed that an FCM or a clearing organization may both buy and sell the permitted investments pursuant to agreements for resale or repurchase of the instruments.

The proposal includes several provisions intended to minimize credit risk, volatility risk and liquidity risk. These features include: (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 money market mutual funds 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 money market mutual funds; (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 recorded in the records of the FCM or clearing organization. The Commission recognizes that events beyond the control of an FCM or clearing organization could cause a portfolio to exceed the time-to-maturity and concentration requirements. Accordingly, the Commission would permit portfolios to be adjusted within a reasonable period of time to meet these requirements. The Commission plans to modify the segregation computation schedule, which is prepared by FCMs every day, to reflect changes in value of the investments.

As noted above, in addition to expanding the list of permitted investments, the proposal would allow investments to be bought and sold pursuant to agreements for repurchase or resale of the instruments. These transactions are usually simply referred to as "repurchase transactions." This part of the proposal essentially incorporates Division of Trading and Markets Financial and Segregation Interpretation No. 2-1 (Interp. 2-1)<sup>26</sup> with three significant modifications. First, in order to increase the liquidity of the segregated portfolio, repurchase transactions will be permitted for the first time. (Interp. 2-1 currently only permits reverse repurchase transactions.) Second, the 180-day cap on the time-to-maturity of collateral subject to reverse repurchase agreements, contained in footnote No. 13 of Interp. 2-1, has been deleted. The Commission has been persuaded by comment received regarding Interp. 2-1 that collateral of any maturity would serve adequately, subject to other regulatory protections in place such as capital charges. Third, the Depository Trust Corporation has been added as a permitted depository for securities. If this rule proposal is adopted by the Commission, it will take the place of Interp. 2-1, which will be rescinded.

The Commission notes that the specific safeguards applicable to the permitted investments set forth in Rule 1.25 will not be the only protections in place. The Commission's proposed Rule

1.25 would take its place as part of a broad set of protections built into the system intended to guard against financial risk at FCMs. First, FCMs generally must meet the Commission's net capital and segregation requirements, as well as SRO requirements. An FCM that is a contract market clearing member also will likely have capital requirements that are higher than those set by the Commission. Second, Commission regulations require firms to keep current books and records, prepare a daily segregation computation and a formal, monthly capital calculation, among other things. Further, an early-warning system requires FCMs to report certain events to the Commission and the SROs. These requirements serve as elements of the overall system of controls to protect segregated funds.

The Commission recognizes that some adjustments may be desirable before the proposal is adopted in final form. Accordingly, the Commission seeks industry and public comment on a number of issues:

- Whether the proposed list of investments is appropriate for segregated funds investments, considering the primary objective of safety of principal;
- Whether the proposed list of investments would create any risks that are not properly contained by the risk-limiting features of the proposed rule and, if so, what additional features should be provided for in the rule;
- The proposed rule contains credit-rating standards and a cap on the dollar-weighted average for the time-to-maturity of investments held in the portfolio. The Commission notes that certain types of structured notes may have significant prepayment and other risks, because they offer a large variety of payment obligations and, therefore, present substantial market and liquidity risks in addition to credit risk. Does the rule sufficiently address this type of exposure?;
- Whether the proposed standards for money market funds are appropriate;
- Whether there are other categories of funds that could be included, and, if so, pursuant to what standards; and
- As is currently the case under Interp. 2-1, the proposed rule limits the permitted counterparties in purchases or sales of securities subject to a repurchase agreement. The Commission requests comment on whether the class of permitted counterparties should be expanded and, if so, to what extent.

The Commission is also proposing 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 rules thereunder. The proposed elimination of the requirement that an FCM obtain a clearing organization acknowledgment is 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 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. These proposed rule amendments would codify a staff no-action letter issued three years ago.<sup>27</sup> An FCM's obligation to obtain written acknowledgments from banks, trust companies and other FCMs, and a clearing organization's obligation to obtain written acknowledgments from banks and trust companies, concerning the treatment of customer funds would be unaffected.

#### *D. Core Principle Four: Risk Disclosure and Account Statements*

As reflected in the fourth Core Principle, the disclosure of risks by intermediaries is an important customer protection. Over the years, however, certain persons have suggested that customers would be better protected by receiving risk disclosures more attuned to their relative level of sophistication and to the particular instruments they trade. Other commenters have suggested that disclosure obligations could be simplified and streamlined.

In keeping with these observations, the Commission proposes that non-institutional customers continue to receive the risk disclosures regarding futures and options trading that are currently required. Thus, intermediaries will continue to be required to obtain prior acknowledgement by non-institutional customers of their receipt of the basic risk disclosure statements relating to futures and options in accordance with Rules 1.55 and 33.7.

The Commission is proposing that the account opening process be streamlined, however, in certain areas. The Commission would permit certain required disclosures, such as those concerning consent to allow cross-trades or to transfer funds out of segregated accounts to another account (such as a money market account), to be included in a customer agreement and acknowledged through a "single

<sup>26</sup> 1 Comm. Fut. L. Rep. ¶ 7112A (December 15, 1993).

<sup>27</sup> CFTC Staff Letter No. 97-45, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,085 (May 5, 1997).

signature” (which could include an electronic signature as provided for in recently-adopted Commission Rules 1.3(t) and 1.4),<sup>28</sup> rather than the multiple signatures that are currently required.<sup>29</sup> In order to enhance the “single-signature” format for account opening agreements, the Commission would amend Rules 1.55(d)(1) and (2) by expanding the list of disclosures and consents that may be provided in a single document and acknowledged with a single signature to include: (1) The disclosures required by new Rule 1.33(g) (relating to electronic transmission of statements);<sup>30</sup> (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. Disclosure concerning arbitration of disputes, however, would continue to require a separate signed acknowledgment by non-institutional customers, pursuant to proposed new Rule 166.5 (this proposed new rule would replace and is modeled on current Rule 180.3).<sup>31</sup> The Commission

<sup>28</sup> 65 FR 12466 (March 9, 2000).

<sup>29</sup> This would reverse existing Commission policy. See 58 FR 17495, 17499 (April 5, 1993).

<sup>30</sup> See proposed changes to Rule 1.33, below.

<sup>31</sup> Part 180 is proposed to be deleted in its entirety, as detailed elsewhere in today’s **Federal Register**. The Commission is also proposing to add a new Rule 166.5 to govern the use of pre-dispute arbitration agreements for customer claims and grievances arising out of transactions executed on or subject to the rules of a contract market, an RFE or a DTF. Proposed Rule 166.5 restates current Rule 180.3, while taking into account the additional trading facilities that may be available to customers. Proposed Rule 166.5 also expands the use of the “single-signature” format for account opening agreements to include, in addition to entities that are excluded from the definition of a commodity pool operator under Rule 4.5 and “qualified eligible participants” as defined in Rule 4.7, institutional customers as defined in proposed Rule 1.3(g) and “qualified eligible clients” as defined in Rule 4.7. Since certain of the persons currently eligible to use the single signature format are included within the proposed definition of institutional customer, the provisions of proposed Rule 166.5(c)(2) contain modifications of rule 180.3(b)(2) so as to avoid duplication. The Commission is also proposing to include within the group of persons who need not separately endorse the provisions of a pre-dispute arbitration agreement persons other than those who would be defined as institutional customers. The Commission is making this proposal because the institutional customer definition would not include all of those now eligible for the single signature treatment under Rule 180.3(b)(2) (e.g., a foreign insurance company or a qualified eligible participant) and the Commission does not intend to restrict, but rather intends to expand, this aspect of the rule. The proposed rule further recognizes that a registered futures association may be authorized to act as a decision-maker in customer dispute resolution proceedings involving floor brokers that are not members of the registered futures association and makes additional stylistic changes designed to make the rule more readable.

specifically requests comment on whether to continue to require a separate signed acknowledgment by non-institutional customers of a pre-dispute arbitration agreement.

In contrast, for institutional customers, as provided in Rule 1.55(f), there would continue to be no specific disclosure requirements.<sup>32</sup> Because the definition of institutional customer referred to above would include governmental entities, these entities would not be required to receive and to acknowledge a disclosure statement. This reverses the position that the Commission took when it last amended its risk disclosure rules two years ago.<sup>33</sup>

Finally, the Commission is considering developing more streamlined disclosure requirements for domestic exchange-traded options under Rule 33.7. The Commission therefore seeks comments regarding how such disclosure may be more effectively presented to customers while reducing the associated burdens on registrants.

#### *E. Core Principle Five: Trading Standards*

Under the Core Principles, intermediaries and their affiliated persons are prohibited from misusing knowledge of their customers’ orders. Currently, FCMs and IBs are required to establish and to maintain supervisory procedures to assure that neither they nor any affiliated persons (as defined in Rule 155.1) abuse their knowledge of customer orders to the customer’s disadvantage. These rules have proven effective in the Commission’s efforts to curb such practices as “front-running,” “trading ahead,” “bucketing,” taking the opposite side of customer orders, or improper disclosure of customer orders to third parties. Indeed, the Commission has found that these rules have generated few comments from industry professionals. The Commission therefore proposes that Rules 155.1, 155.3 and 155.4 will continue to apply to intermediation of trades at contract markets, RFEs, and for non-institutional customers’ trades at DTFs. See proposed new Rule 155.6(a).

For intermediation of trades by institutional customers at DTFs, the Commission is proposing a new Rule 155.6(b) setting forth a general standard

<sup>32</sup> In this regard, the Commission would, with industry input, issue a Statement of Acceptable Practices on disclosure to institutional customers at a later date.

<sup>33</sup> 63 FR 8566, 8568 (February 20, 1998). Particular governmental entities and trade associations for such entities are, of course, free to establish their own restrictions concerning futures trading through statute, regulation or Statements of Acceptable Practices.

of practice in this area. The rule would simply parallel the language of the Core Principle prohibiting the misuse of knowledge of customer orders. Although the proposed new Rule 155.6(b) would not include as much detail as the current trading standards rules, it is nevertheless intended to proscribe the same trade practice abuses as Rules 155.1–155.5. Such practices as “front-running,” “trading ahead,” “bucketing,” taking the opposite side of customer orders, or disclosure of customer orders to third parties, would thus be deemed to be misuse of knowledge of customer orders and violations of Rule 155.6. The Commission will consider the development of a Statement of Acceptable Practices to be issued at a later date, with the consultation of DTFs, regarding appropriate procedures that should be employed in order to ensure compliance with the general standard.<sup>34</sup>

#### *F. Core Principle Seven: Reporting Requirements*

The Commission has found that its reporting system provides a valuable bulwark against illegitimate trade practices. Accordingly, the Commission would continue, and apply to intermediaries on RFEs, its large trader reporting requirements. Thus, FCMs would be required to report to the Commission and RFEs information that permits the identification of concentrations of positions and market composition on a routine and nonroutine basis, and information to detect manipulation, price distortion and disruptions of the delivery or cash settlement process.

With respect to intermediaries transacting business on DTFs, however, because of the nature of the instruments traded or the limited access granted thereto for non-institutional traders, the Commission would reduce its reporting requirements. Such intermediaries would only be subject to large trader reporting requirements by special call. These proposed reforms are detailed elsewhere in today’s **Federal Register**.

<sup>34</sup> As noted above, the DTF is at this point a proposed new institution, and it is not known how such institutions would choose to operate. Such institutions may choose to sponsor trading in a traditional open-outcry pit trading system with natural persons acting as FBs or FTs. On the other hand, some DTFs may choose a purely automated, electronic trading format, or a combination of open outcry and electronic trading. Because it cannot be known at this time how such entities will choose to organize themselves, and what policies they will wish to pursue, the Commission is not at this time issuing a Statement of Acceptable Practices in this area.

*G. Core Principal Eight: Recordkeeping*

## 1. General

The Core Principles maintain that all registrants must keep full books and records of their activities related to their business. Thus, the Commission would maintain recordkeeping requirements as they relate to intermediaries, while considering whether greater use may be made of information technology in this regard. The Commission notes that Rule 1.31 was recently revised to provide for enhanced electronic recordkeeping similar to SEC recordkeeping requirements. See 64 FR 36568 (July 7, 1999); 64 FR 28735 (May 27, 1999). The Commission seeks comments regarding Rule 1.31 and on how greater use of information technology may be made in the future for recordkeeping purposes.

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

In keeping with changes in technology and commercial practices, the Commission is proposing to codify its previous Advisory relating to the electronic transmission of account statements, 62 FR 31507 (June 10, 1997), in a new Rule 1.33(g). 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. In keeping with the above-referenced Advisory, 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, to satisfy recordkeeping obligations.

Proposed Rule 1.33(g) also provides, as did the above-referenced Advisory, that an FCM must, prior to the transmission of any statement by means of electronic media, disclose (1) The electronic medium or source through which statements will be delivered, (2) the duration, whether indefinite or not, of the period during which consent will be effective, (3) any charges for such service, (4) the information that will be delivered electronically, and (5) that consent to electronic delivery may be revoked at any time. In the case of a non-institutional customer, an FCM must obtain the non-institutional customer's signed consent acknowledging disclosure of this information prior to the transmission of any statement by means of electronic media. This acknowledgment can be included in a customer account agreement and acknowledged through a single signature in accordance with Rule 1.55. Institutional customers would not need to provide written consent, and the

Commission recommends that FCMs confirm procedures relating to electronic transmission of statements to institutional customers as described in the above-referenced Advisory. The Commission specifically requests comment, however, as to whether FCMs may treat non-institutional customers in the same manner as institutional customers are proposed to be treated in this area. Any statement required to be furnished to a person other than a customer in accordance with paragraph (d) of Rule 1.33 would also be permitted to be furnished by electronic media.

The Commission also proposes to revise Rule 1.46 so that its general standard would function as a default rule in the absence of instruction by a customer or account controller. The Rule currently requires, absent one of several exceptions, that an FCM close out offsetting positions on a first-in, first-out basis, looking across all accounts it carries for the same customer.<sup>35</sup> Under the proposed rule, any customer or account controller could instruct the FCM otherwise, so that offsetting positions could be held open or closed out on other than a first-in, first-out basis. CPOs and CTAs would be required to disclose if they operate in this fashion, by amending Rules 4.24(h)(2) (which applies to CPOs) and 4.34(h) (which applies to CTAs) to include reference to the CPO's or CTA's instructions to FCMs concerning application of offsetting positions pursuant to Rule 1.46.

In order to implement this revision of Rule 1.46, the Commission proposes to amend the rule by inserting, after the words "omnibus accounts" in paragraph (a), the phrase "or where the customer or account controller has instructed otherwise." Rule 1.46 also would be amended by revising paragraph (e) to correspond to proposed new Rule 1.33(g) (the substance of the current paragraph (e) of Rule 1.46 would be deleted because it currently relates back to paragraph (d)(6), which is being removed and reserved) to read: "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)."

<sup>35</sup> An FCM must take into consideration positions in separate accounts of the same customer that it is carrying in applying Rule 1.46. 57 FR 55082, 55083 n. 2 (November 24, 1992), *citing* U.S. Department of Agriculture, Commodity Exchange Authority Administrative Determination No. 134 (May 25, 1948).

**III. 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 rule amendments discussed 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.<sup>36</sup> The Commission has previously determined that registered FCMs, CPOs, LTMs and ATOMs are not small entities for the purpose of the RFA.<sup>37</sup> 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.

The amendments proposed herein would not require any registrant to change its current method of doing business. For many registrants, the proposed revisions should decrease the number of persons within the registrant's organization who would be considered principals under the CFTC rules. Further, the proposed 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 these proposed amendments will not have a significant economic impact on a substantial number of small entities.

*B. Paperwork Reduction Act*

As required by the Paperwork Reduction Act of 1995 [44 U.S.C. 3507(d)], the Commission has submitted a copy of these proposed amendments to its rules to the Office of Management and Budget for its review.

## Collection of Information

Rules Relating to the Operations and Activities of Commodity Pool Operators and Commodity Trading Advisors and to Monthly Reporting by Futures

<sup>36</sup> 47 FR 18618-18621 (April 30, 1982).

<sup>37</sup> 47 FR 18619-18620 (discussing FCMs and CPOs); 54 FR 19556, 19557 (May 8, 1989) (discussing LTMs); and 63 FR 18821, 18830 (April 16, 1998) (discussing ATOMs).

Commission Merchants, OMB Control Number 3038-0005.

The Commission believes that the amendments to Part 4 of its regulations impose no burden. While these proposed rule amendments have no burden, the group of rules (3038-0005) of which the rules proposed to be amended are a part, has the following burden:

*Average burden hours per response:* 7.25.

*Number of respondents:* 7,362.

*Frequency of response:* Monthly, Quarterly, Annually, On Occasion.

Rules Pertaining to Contract Markets and Their Members, OMB Control Number 3038-0022.

The Commission believes that the amendments to Parts 1 and 155 of its regulations impose no burden. While these proposed rule amendments have no burden, the group of rules (3038-0022) of which the rules proposed to be amended are a part, has the following burden:

*Average burden hours per response:* 2.

*Number of respondents:* 15,894.

*Frequency of response:* On Occasion.

Rules, Regulations and Forms for Domestic and Foreign Futures and Options Relating to Registration with the Commission, OMB Control Number 3038-0023.

The expected effect of the proposed amended rule will be to reduce the burden previously approved by OMB for this collection by 5,521.8 hours.

Specifically: The burden associated with Commission Rule 3.10(a) as applied to FCMs is expected to be decreased by 2 hours:

*Estimated number of respondents (after proposed amendment):* 6.

*Annual responses by each respondent:* 1.

*Estimated average hours per response:* 0.5.

*Annual reporting burden:* 3 hours.

The burden associated with Commission Rule 3.10(a) as applied to IBs is expected to be decreased by 54.8 hours:

*Estimated number of respondents (after proposed amendment):* 343.

*Annual responses by each respondent:* 1.

*Estimated average hours per response:* 0.4.

*Annual reporting burden:* 137.2 hours.

The burden associated with Form 8-R is expected to be decreased by 132 hours:

*Estimated number of respondents (after proposed amendment):* 2,400.

*Annual responses by each respondent:* 1.

*Estimated average hours per response:* 0.33.

*Annual reporting burden:* 792 hours.

The burden associated with Commission Rule 3.32 is expected to be decreased by 1 hour:

*Estimated number of respondents (after proposed amendment):* 10.

*Annual responses by each respondent:* 1.

*Estimated average hours per response:* 0.2.

*Annual reporting burden:* 2 hours.

The recordkeeping and reporting burdens associated with Commission Rule 3.34 are expected to be decreased by 5,332 hours:

*Estimated number of respondents (after proposed amendment):* 0.

*Annual responses by each respondent:* 0.

*Estimated average hours per response:* 0.

*Annual reporting burden:* 0 hours.

Regulations and Forms Pertaining to the Financial Integrity of the Marketplace, OMB Control Number 3038-0024.

The expected effect of the proposed amended rule will be to reduce the burden previously approved by OMB for this collection by 7.5 hours.

Specifically: The burden associated with Commission Rule 1.10 is expected to be decreased by 7.5 hours:

*Estimated number of respondents (after proposed amendment):* 15.

*Annual responses by each respondent:* 1.

*Estimated average hours per response:* 1.

*Annual reporting burden:* 15 hours.

Copies of the information collection submission to OMB are available from the CFTC Clearance Officer, 1155 21st Street NW., Washington, DC 20581, (202) 418-5160.

Persons wishing to comment on the information collection requirements that would be required by these proposed rules should contact the Office of Information and Regulatory Affairs, Office of Management and Budget, Room 10235, New Executive Office Building, Washington, DC 20503, Attn: Desk Officer for the Commodity Futures Trading Commission.

The Commission considers comments by the public on this proposed collection of information in—

- Evaluating whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information will have a practical use;

- Evaluating the accuracy of the Commission's estimate of the burden of the proposed collection of information including the validity of the methodology and assumptions used;

- Enhancing the quality, utility, and clarity of the information to be collected; and

- Minimizing the burden of the collection of the information on those who are to respond, including through the use of appropriate automated, electronic, mechanical or other technological collection techniques or other forms of information technology, e.g. permitting electronic submissions of responses.

OMB is required to make a decision concerning the collection of information contained in these proposed regulations between 30 and 60 days after publication of this document in the **Federal Register**. Therefore, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. This does not affect the deadline for the public to comment to the Commission on the proposed regulations.

Copies of the information collection submission to OMB are available from the CFTC Clearance Officer, 1155 21st Street NW, Washington, DC 20581 (202) 418-5160.

#### Lists 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, Reporting and recordkeeping requirements, Registration, Principals.

##### 17 CFR Part 4

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

##### 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, 4b, 4d, 4f, 4m, 4n, 8a, and 19 thereof, 7 U.S.C. 2, 6b, 6d,

6f, 6m, 6n, 12a and 23, the Commission hereby proposes to amend 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 proposed to be amended by adding a new paragraph (g) 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.

\* \* \* \* \*

3. Section 1.10 is proposed to be amended as follows:

- a. Revising paragraph (a)(2)(i)(B);
- b. Adding paragraph (a)(2)(i)(C);
- c. Designating the undesignated paragraph following paragraph (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, *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, *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 proposed to be 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 non-institutional customer 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.

\* \* \* \* \*

- (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 bylaws, rules, regulations or resolutions.

\* \* \* \* \*

5. Section 1.20 is proposed to be 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 proposed to be 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) 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 insured by the Federal Deposit Insurance Corporation;

(v) Commercial paper;

(vi) Corporate notes; and

(vii) 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 (vii) 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) *Ratings—(i) Initial requirement.* Instruments that are required to be rated by this section must be rated by a nationally recognized statistical rating organization (NRSRO), as that term is defined in § 270.2a-7 of this title. Ratings are required for permitted investments as follows:

(A) U.S. government securities 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 or, if the fund is not rated, investments made by the fund must comply with the requirements applicable to direct investments under this section.

(ii) *Effect of downgrade.* If an NRSRO lowers the rating of an instrument that was previously a permitted investment 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.

(2) *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)(2)(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.

(3) *Concentration.* (i) The aggregate investment in U.S. government securities or in money market mutual funds shall not be subject to a concentration limit.

(ii) The aggregate investment in the securities of any one issuer, or related issuers, of government sponsored agency securities shall not exceed 25 percent of the total assets held in segregation by the futures commission merchant or the clearing organization. Securities issued by an entity that directly or indirectly constitute an interest in securities issued by a government sponsored agency shall be combined and treated as the securities of a single issuer for the purpose of determining the concentration limit.

(iii) The aggregate investment in the obligations of any one issuer, or related issuers, of any permitted investments, other than U.S. government securities, money market mutual funds, and government sponsored agency instruments, may not exceed five percent of the total assets held in segregation by the futures commission merchant or the clearing organization.

(4) *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.

(5) *Investments in instruments issued by affiliates.* (i) Except as provided in paragraph (b)(5)(ii) of this section, 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 provided that the

fund itself does not invest in any instrument issued by the futures commission merchant, clearing organization or affiliate thereof.

(6) *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 registered with the Securities and Exchange Commission as a money market mutual fund, in compliance with applicable requirements. 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, 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 hold its shares of the fund in a custody account 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 daily by 9 a.m. of each business day and made available to the futures commission merchant or clearing organization by that time.

(5) An interest in a fund must be able to be liquidated by the business day following a request to liquidate by the 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 pursuant to agreements for resale or repurchase of the securities (repurchase transactions), provided the agreements for resale or repurchase conform to the following requirements:

(1) The securities are specifically identified by coupon rate, par amount, market value, maturity date, and CUSIP 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 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)(11) of this section and which states that the parties thereto intend the transaction to be treated as a purchase and sale of securities.

(4) The term of the agreement is no more than one business day, or reversal of the transaction is possible on demand.

(5) 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 Corporation in an account that complies with the requirements of § 1.26.

(6) 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 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.

(7) 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.

(8) 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.

(9) 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.

(10) 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."

(11) 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) 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 proposed to be 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, 1.28 and 1.29 [Amended]**

8. Sections 1.27, 1.28 and 1.29 are proposed to be amended by revising the word "obligations" to read "instruments" each time it appears.

9. Section 1.33 is proposed to be 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 non-institutional customer, a futures commission merchant must obtain the non-institutional 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.

10. Section 1.46 is proposed to be 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:

\* \* \* \* \*

(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).

11. Section 1.52 is proposed to be 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).

12. Section 1.55 is proposed to be 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**

13. 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.

14. Section 3.1 is proposed to be 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

\* \* \* \* \*

15. Section 3.10 is proposed to be 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 exclusively on or subject to the rules of a 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 exclusively on or subject to the rules of a 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.

16. Section 3.32 is proposed to be amended as follows:

a. Adding paragraphs (a)(1)(i)(A) and (B);

b. Revising paragraphs (a)(1)(ii) and (a)(1)(v);

c. Redesignating paragraphs (a)(1)(vi) and (a)(1)(vii) as paragraphs (a)(1)(vii) and (a)(1)(viii), respectively;

d. Adding a new paragraph (a)(1)(vi);

e. Revising paragraph (a)(2)(i); and

f. Revising paragraph (e)(1).

The revisions and additions read as follows:

**§ 3.32 Changes requiring new registration; addition of principals.**

(a)(1) \* \* \*

(i) \* \* \*

(A) As an individual, directly or indirectly, through agreement, holding company, nominee, trust or otherwise, becomes the owner of ten percent or more of the outstanding shares of any class of stock or acquires the right to vote or the power to sell or to direct the sale of ten percent or more of the registrant's voting securities;

(B) Any person other than an individual that becomes the direct owner of ten percent or more of any class of a registrant's securities;

(ii) As an individual becomes entitled to receive ten percent or more of the registrant's profits;

\* \* \* \* \*

(v) Becomes the president, chief executive officer, chief operating officer or chief financial officer of the corporate registrant, or becomes in charge of a principal business unit, division or function subject to regulation by the Commission, or comes to occupy a position of similar status or perform a similar function;

(vi) Becomes a director, president, chief executive officer, chief operating officer, chief financial officer, manager, managing member or a member vested with the management authority for the registrant or becomes in charge of a principal business unit, division or function subject to regulation by the Commission, or comes to occupy a position of similar status or perform a similar function in the case of a limited liability company or limited liability partnership;

\* \* \* \* \*

(2)(i) If a person becomes a principal of the registrant because of an event described in paragraph (a)(1)(i)(B) of this section, the registrant's registration shall not be deemed to terminate and a new Form 7-R need not be filed;

*Provided, however,* that within twenty days of the occurrence of the event described in paragraph (a)(1)(i)(B) of this section, the registrant must notify the National Futures Association of the name of such added principal on Form 3-R and must file written certifications

with the National Futures Association stating:

(A) The ultimate day-to-day control of the registrant remains the same,

(B) The addition of the new principal will not affect the conduct or the day-to-day operations of the registrant, and

(C) The insertion of the new principal into the chain of ownership is not being done for the purpose, and will not have the effect, of limiting any liability of the registrant.

\* \* \* \* \*

(e)(1) Except where a registrant chooses to file an application pursuant to paragraph (d) of this section, if applicable, in the event of a change as described in paragraph (a)(1)(v) or (a)(1)(vi) of this section, a new registration will not be required if the registrant submits a written notice on Form 3-R to the National Futures Association prior to the date of such change in control (and such change does not occur until the registrant receives written approval from the National Futures Association) and includes with such notice a Form 8-R, completed in accordance with the instructions thereto and executed by the person referred to in paragraph (a)(1)(v) or (a)(1)(vi) of this section. The Form 8-R for such individual must be accompanied by the fingerprints of that individual on a fingerprint card provided for that purpose by the National Futures Association: *Provided, however,* That a fingerprint card need not be provided under this paragraph for any individual who has a current Form 8-R on file with the National Futures Association or the Commission.

\* \* \* \* \*

**§ 3.34 [Removed]**

17. Section 3.34 is proposed to be removed.

18. Part 3 is proposed to be 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 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**

19. 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.

20. Section 4.10 is proposed to be 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.

\* \* \* \* \*

21. Section 4.24 is proposed to be 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 foregoing persons 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;

\* \* \* \* \*

22. Section 4.34 is proposed to be 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**

23. The authority citation for Part 140 continues to read as follows:

**Authority:** 7 U.S.C. 4a, 12a.

24. Section 140.91 is proposed to be 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**

25. 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.

26. Sections 155.2, 155.3, 155.4 and 155.5 are proposed to be amended by adding the words “or recognized futures exchange” after the words “contract market” each time they appear.

27. Section 155.6 is proposed to be 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 non-institutional customer 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**

28. The authority citation for Part 166 is proposed to be 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.

29. Section 166.5 is proposed to be 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.

(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) An institutional customer as defined in § 1.3(g) of this chapter;

(ii) 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

(iii) A person who is a “qualified eligible participant” or a “qualified eligible client” 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

demand 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 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 exchanges 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 exchanges 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 exchanges or derivatives transaction facility does not have jurisdiction. Other counterclaims are permissible only if the customer agrees to the submission after the counterclaim has arisen, and if the aggregate monetary

value of the counterclaim is capable of calculation.

Issued in Washington, DC on June 8, 2000, by the Commission.

Jean A. Webb,

Secretary of the Commission.

[FR Doc. 00-14915 Filed 6-21-00; 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:** Proposed Rulemaking.

**SUMMARY:** The Commodity Futures Trading Commission (Commission) is proposing a new Part 39 of its rules that would apply to clearing organizations, as defined in the proposed rules. This proposal, centered on broad, flexible, core principles, is part of an initiative described in separate companion releases published in this edition of the **Federal Register** proposing a new regulatory framework applicable to multilateral transaction execution facilities and market intermediaries, in addition to clearing organizations. These notices propose far-reaching and fundamental changes to modernize Federal regulation of commodity futures and option markets.

**DATE:** Comments must be received by August 7, 2000.

**ADDRESSES:** Comments should be sent to the Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581, attention: Office of the Secretariat. Comments may be sent by facsimile transmission to (202) 418-5521 or, by e-mail to secretary@cftc.gov. Reference should be made to "clearing organizations reinvention."

**FOR FURTHER INFORMATION CONTACT:** Paul M. Architzel, Chief Counsel, Division of Economic Analysis, 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

The Commission is proposing a new Part 39 regulatory framework that would apply to clearing organizations (*i.e.*, entities that perform a credit enhancement function by becoming a universal counterparty to market participants or by operating a facility for the netting of obligations and payments). This proposal, centered on broad, flexible, core principles, is part of an initiative described in separate companion releases published in this edition of the **Federal Register** proposing a new regulatory framework applicable to multilateral transaction execution facilities and to market intermediaries.

Clearing organizations perform valuable functions in exchange-traded futures and option markets. They serve to mitigate counterparty credit risk, facilitate the netting and offsetting of contractual obligations, and decrease systemic risk. The development of similar clearing facilities for the clearing of over-the-counter derivatives should be encouraged.<sup>1</sup> However, the performance of these functions may raise concerns regarding concentration of financial and credit risk in a single entity. Accordingly, clearing organizations should be subject to regulatory oversight to ensure that such facilities are capitalized sufficiently and that they establish and implement a risk management program that is designed to control the credit concentration risk associated with centralized clearing. The Commission notes that it currently oversees the clearing organizations that are associated or affiliated with U.S. futures and option exchanges.<sup>2</sup>

The Commission is proposing to require, pursuant to proposed part 39 of its regulations, that certain transactions be cleared only by recognized clearing organizations (RCOs). An entity may become recognized by the Commission

by effectively demonstrating that it satisfies core principles covering, among other areas, financial resources, risk management, treatment of client funds and settlement procedures. U.S. clearing organizations that currently perform clearing services for transactions executed on domestic futures and option exchanges generally satisfy the core principles and, thus, would not be required to make any additional showing or change their method of operation. Consistent with recommendations made in the President's Working Group report,<sup>3</sup> the Commission recognizes that the form and degree of regulatory oversight imposed upon a clearing organization should be consistent with the types of instruments and markets for which it clears and the class of market participants for whom it clears. Part 39 would specify entities other than and in addition to RCOs that could serve as clearing organizations for transactions executed pursuant to part 35 of the Commission's regulations or effected on an exempt multilateral transaction execution facility under part 36 of the Commission's regulations. These entities may be: (1) A securities clearing agency regulated by the Securities and Exchange Commission (SEC); (2) a clearing system organized as, among other things, a bank, and subject to the jurisdiction of the Board of Governors of the Federal Reserve System; or (3) a foreign clearing organization that demonstrates to the Commission that it: (a) Is subject to home country regulation and oversight comparable to the standards set forth by the Commission for recognition of clearing organizations under part 39; and (b) is a party to and abides by appropriate and adequate information-sharing agreements.

## II. The Proposed Rules

Proposed part 39 rules would require that every transaction effected on a designated contract market, recognized futures exchange or derivatives transaction facility, if cleared, be cleared by an RCO. RCOs also would be authorized to clear transactions that are exempt under part 35 or part 36. RCOs would not be required by part 39 to be affiliated with any of the foregoing entities. Moreover, nothing in the Commission's rules prohibits an RCO from clearing any other type of cash market or derivative instrument.<sup>4</sup> In

addition to RCOs, the following entities also are authorized to clear transactions exempt under part 35 or part 36 of the Commission's rules: (1) Securities clearing agencies subject to the supervisory jurisdiction of the SEC; (2) clearing systems organized as a bank, bank subsidiary, bank affiliate, or Edge Act corporation;<sup>5</sup> or (3) foreign clearing organizations that demonstrate to the Commission that they are: (i) Subject to home country regulation and oversight comparable to the standards set forth by the Commission for recognition of clearing organizations under part 39; and (ii) parties to appropriate and adequate information-sharing agreements. The Commission would defer to oversight by the clearing organization's primary regulator in connection with the clearance of such exempt transactions.

To be recognized as an RCO, an entity must have already been clearing nondormant contracts on a U.S.-designated contract market as of January 1, 2000, or must apply to the Commission for recognition as an RCO under part 39. An application would address how the core principles would be satisfied by the applicant's proposed rules, procedures, and framework for operation by addressing the matters set forth in the guidance provided to applicants in the appendix to part 39.

A clearing organization seeking recognition would be deemed recognized sixty days after the Commission received the application, unless it appeared that the applicant and/or its rules or procedures might violate a specific provision of the Commodity Exchange Act (Act), or the Commission's regulations or the form and content requirements of part 39. In that event, the Commission could notify the applicant that the Commission would review the proposal under the procedures of section 6 of the Act.<sup>6</sup> An

particular commodities and what steps can be taken to address them.

<sup>5</sup> 12 U.S.C. 611 *et seq.* An Edge Act corporation is an organization chartered by the Federal Reserve to engage in international banking operations. The Federal Reserve Board acts upon applications by U.S. and foreign banking organizations to establish Edge Act corporations. It also examines Edge Act corporations and their subsidiaries. The Edge Act corporation gets its name from Senator Walter Edge of New Jersey, the sponsor of the original legislation to permit formation of such organization.

<sup>6</sup> Section 6 of the Act is applicable to clearing organizations as well as contract markets. Commission Regulation 1.41(a)(3) defines the term "contract market" to include a clearing organization that clears trades for a contract market. The authority of the Commission to define and treat a clearing organization as a contract market for purposes of the Act and the Commission's regulations was upheld in Board of Trade Clearing Corporation v. U.S., (DCDC Jan 11, 1978), '77-'80 CCH Dec. ¶ 20,534.

<sup>1</sup> See the Report of the President's Working Group on Financial Markets, *Over the Counter Derivatives Markets and the Commodity Exchange Act* (Nov. 1999).

<sup>2</sup> The Commission is aware of the standards set forth in the Bank of International Settlements' 1993 Lamfalussy Report on multilateral netting systems, the recommendations with respect to clearing and settlement of securities transactions of the Group of Thirty, a private sector group representing leading banking and securities firms from around the world, and the recommendations of the President's Working Group in response to the market break of October, 1987. Currently existing clearing organizations for U.S. futures and options exchanges meet or exceed these standards and recommendations as a result of the Commission's review of these entities' rules and procedures and the Commission's ongoing oversight program. These standards and recommendations, along with others, were taken into account in formulation proposed part 39.

<sup>3</sup> See footnote 1, above.

<sup>4</sup> Indeed, the benefits of clearing noted above could be enhanced were RCOs to clear both cash market and derivative instruments. In this regard, the Commission seeks comment on what obstacles, if any, exist to combining such clearing functions in an RCO, whether such obstacles are specific to

entity seeking recognition as an RCO may request that the Commission approve its initial set of rules under section 5a(a)(12)(A) of the Act and Commission regulations thereunder.

Part 39 rules would provide that, after an entity was recognized as an RCO, it would submit new rules and rule amendments to the Commission pursuant to proposed amended Commission regulation 1.41. An RCO also could request the Commission to approve new rules or rule amendments under section 5a(a)(12)(A) of the Act and Commission regulation 1.41. An RCO also could request the Commission to issue an order considering whether the RCO, in adopting and implementing a rule, endeavored to take the least anticompetitive means of achieving the objective, purposes, and policies of the Act.

The fraud and manipulation provisions of the Act would apply with respect to transactions cleared by an RCO.

### III. Related Matters

#### A. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA"), 5 U.S.C. 601–611, requires that agencies, in proposing regulations, consider the impact of those regulations on small entities. Information of the type that would be required under the proposed rule does not involve any small organizations.

#### B. Paperwork Reduction Act

Part 39 contains information collection requirements. As required by the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)), the Commission has submitted a copy of this part to the Office of Management and Budget ("OMB") for its review.

#### Collection of Information

Submissions of Applicants for Recognition as Recognized Clearing Organizations, OMB Control Number 3038–XXXX.

The burden associated with the proposed new part is estimated to be 2,000 hours which will result from new submission requirements for first-time applicants for recognition as Recognized Clearing Organizations.

The estimated burden of the proposed new part was calculated as follows:

*Estimated number of respondents:* 10.  
*Reports Annually by each respondent:* 1.

*Total Annual Responses:* 10.  
*Estimated Average Number of Hours Per Response:* 200.

*Estimated Total Number of Hours of Annual Burden in Fiscal Year:* 2,000.

Organizations and individuals desiring to submit comments on the

information collection requirements should direct them to the Office of Information and Regulatory Affairs, OMB, Room 10235 New Executive Office Building, Washington, DC 20503, Attention: Desk Officer for the Commodity Futures Trading Commission.

The Commission considers comments by the public on this proposed collection of information in—

- Evaluating whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information will have a practical use;
- Evaluating the accuracy of the Commission's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;
- Enhancing the quality, usefulness, and clarity of the information to be collected; and
- Minimizing the burden of collection of information on those who are to respond, including through the use of appropriate automated electronic, mechanical, or other technological collection techniques or other forms of information technology, e.g., permitting electronic submission of responses.

OMB is required to make a decision concerning the collection of information contained in these proposed regulations between 30 and 60 days after publication of this document in the **Federal Register**. A comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. This does not affect the deadline for the public to comment to the Commission on the proposed regulations.

Copies of the information collection submission to OMB are available from the CFTC Clearance Officer, 1155 21st Street, NW, Washington, DC 20581, (202) 418–5160.

#### 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 proposes to amend 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 Definitions and Scope.  
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 and Manipulation in Connection with transactions cleared by a Recognized Clearing Organizations.  
Appendix A to Part 39—Application Guidance

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

#### § 39.1 Definitions and Scope.

(a) Definitions. For purposes of this part:

(1) *Clearing organization* means a person, entity or association thereof, which performs a credit enhancement function in connection with transactions executed on a designated contract market or pursuant to parts 35–38 of this chapter by becoming a universal counterparty to market participants or by operating a facility for the netting of obligations and payments of such transactions; 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.

(b) Scope. (1) This section applies to all cleared 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.

(2) A clearing organization that has been recognized by the Commission under § 39.3 of this part shall be deemed to be a contract market for purposes of the Act, and Commission rules thereunder; provided, however, a recognized clearing organization shall be exempt from all provisions of the Act and Commission regulations thereunder except as reserved in § 39.5 of this part.

#### § 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.

(b) A transaction effected pursuant to Part 35 or Part 36 of this chapter, if cleared, shall be cleared by any of the following authorized clearing organizations:

(1) A recognized clearing organization under this part;

(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) Transactions not specified in § 39.1(b)(1) of this part may also be cleared by a recognized clearing organization.

### § 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 the operation of its clearing function; and

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

(1) Financial resources: Adequate capital resources to fulfill its guarantee function without interruption in various market conditions.

(2) Participant and product eligibility: Appropriate admission and continuing eligibility standards for members or participants of the organization and defined criteria for instruments it will accept for clearing.

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

(4) Settlement procedures: Ability to complete settlements on a timely basis under varying circumstances, to maintain an adequate record of the flow of funds associated with each transaction it clears, and to comply with

the terms and conditions of any permitted netting or offset arrangements with other clearing organizations.

(5) Treatment of client funds: Adequate standards and procedures designed to protect and ensure the safety of client funds.

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

(7) Rule enforcement: Adequate arrangements and resources for the effective monitoring and enforcement of compliance with its rules and for resolution of disputes.

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

(9) Governance: Have 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 have a means to address conflicts of interest in making decisions.

(10) Reporting: Provision to the Commission of all information necessary for the Commission to conduct its oversight function of the clearing organization's activities.

(11) Recordkeeping: Maintain full books and records of all activities related to business as a recognized clearing organization in a form and manner acceptable to the Commission for a period of five years.

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

(13) Information sharing: Enter into and abide by the terms of all appropriate and applicable domestic and international information-sharing agreements and use relevant information obtained from such agreements in carrying out the clearing organization's risk management program.

(14) Competition: Endeavor to avoid unreasonable restraints of trade or imposing any burden on competition not necessary or appropriate in furtherance of the objectives of the Act or the regulations thereunder.

### § 39.4 Procedures for Recognition.

(a) Recognition by certification. A clearing organization that cleared for at least one nondormant contract within the meaning of § 5.4 of this chapter on

January 1, 2000, 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 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 a brief explanation of how the rules satisfy each of the conditions for recognition under § 39.3 of this part;

(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) Attached to this part as Appendix A is guidance to applicants concerning how the core principles set forth above 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, until it orders otherwise, 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. In addition, rules of the recognized clearing organization not submitted pursuant to § 39.4(b)(3) shall be submitted to the Commission pursuant to § 1.41 of this chapter.

(2) 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.

In accordance with the proviso in § 39.1(b)(2), sections 1a, 2(a)(1), 4, 4b, 4c, 4d, 4g, 4i, 4o, 5(7), the rule disapproval procedures of sections 5a(a)(12), 5b, 6, 6b, 6c, 8(a), 8(c), 8a(6), 8a(7), 8a(9), 8c(a), 8c(b), 8(c)(c), 8(c)(d), 9(a), 9(f), 20 and 22 of the Act and §§ 1.3, 1.20, 1.24, 1.25, 1.26, 1.27, 1.31, 1.38, 1.41, 33.10, parts 15–21, part 39,

and part 190 of this chapter continue to apply.

### § 39.6 Fraud and Manipulation in Connection with transactions cleared by a Recognized Clearing Organization.

It shall be unlawful for any person, directly or indirectly, in or in connection with any transaction cleared 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. In addressing the core principles, applicants should address the matters set forth below.

#### Core Principle 1—Financial Resources. Adequate Capital Resources to Fulfill the Guarantee Function Without Interruption in Various Market Conditions

In addressing core principle 1, applicants should 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 such 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 a hypothetical default scenario that explains assumptions and variables factored into the illustration.

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 without delay; and

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

#### Core Principle 2—Participant and Product Eligibility. Appropriate Admission and Continuing Eligibility Standards for Members or Participants of the Organization and Defined Criteria for Instruments it Will Accept for Clearing

In addressing core principle 2, applicants should 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/how the clearing organization would be able to change continuing eligibility criteria in accordance with changes in a member's financial status.

3. Criteria for instruments acceptable for clearing:

a. How the clearing organization would establish specific criteria for the types of derivatives it will clear; and

b. How those criteria take into account the different risks inherent in clearing different derivatives and how they affect maintenance of assets to support the guarantee function in varying risk environments.

4. Clearing function for each instrument:

a. The clearing function for each instrument the organization undertakes to clear; and

b. How different functions would be made known to participants.

#### Core Principle 3—Risk Management. Ability to Manage the Risks Associated With Carrying Out the Guarantee Function Through the Use of Appropriate Tools and Procedures

In addressing core principle 3, applicants should 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 including 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 central counterparty;

c. Why particular margin levels would be appropriate for a contract cleared and the clearing member clearing the contract;

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 ensure appropriate valuation of open positions and valuation of collateral assets; and

f. The proposed margin collection schedule and how it would synchronize with 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 appropriate credit limits; and

4. Appropriate use of cross margin reduction programs:

How collateral assets subject to cross-margining programs would provide for clear,

fair, and efficient loss-sharing arrangements in the event of a program participant default.

*Core Principle 4—Settlement Procedures. Ability To Complete Settlements on a Timely Basis Under Varying Circumstances, To Maintain an Adequate Record of the Flow of Funds Associated With Each Transaction it Clears, and To Comply With the Terms and Conditions of Any Permitted Netting or Offset Arrangements With Other Clearing Organizations*

In addressing core principle 4, applicants should 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 the flow of funds associated with each cleared transaction would be recorded, maintained and easily accessed.
3. Appropriate interfaces with other clearing organizations:
  - a. How compliance with the terms and conditions of any permitted 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 Client Funds. Standards and Procedures Designed To Protect and Ensure the Safety of Client Funds*

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

1. Safe custody:
  - a. The safekeeping of client 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. How the deposit of client funds in accounts in depositories or with custodians would also ensure adequate diversification of concentration of risk.
2. Segregation between customer and proprietary funds:
  - a. Requirements for segregation and requiring members or participants that clear trades executed on behalf of customers to segregate customer accounts and funds; and
  - b. 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, and any other aspects of customer fund segregation.
3. Investment standards:
  - a. How customer funds would be invested to meet high standards of safety and the proposed recordkeeping regarding all details of such investments.

*Core Principle 6—Default Rules and Procedures. Rules and Procedures Designed To Allow for Efficient, Fair, and Safe 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 should describe or otherwise document:

1. Definition of default:
  - a. The definition of default and how it would be established and enforced; and
  - b. How it 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:
  - a. The authority pursuant to which, and how, the clearing organization would 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;
  - b. Process to address shortfalls:
    1. Procedures for the prompt, fair, and safe application of Clearing Organization and/or member financial resources to eliminate any monetary shortfall resulting from a default.
    2. Customer priority rule:
      - a. Rules and procedures regarding priority of customer accounts over proprietary accounts of intermediary members or participants and where applicable, in the context of other programs, such as specialized margin reduction programs like cross-margining or trading links with other exchanges.

*Core Principle 7—Rule Enforcement. Adequate Arrangements and Resources for the Effective Monitoring and Enforcement of Compliance With its Rules and for Resolution of Disputes*

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

1. Surveillance:
  - a. Arrangements and resources for the effective monitoring of compliance with rules including any clearing practice and financial surveillance programs.
2. Enforcement:
  - a. 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; and
  - b. Authority and ability to terminate a member's or participant's activities pursuant to clear and fair standards.
3. Dispute resolution:
  - a. Arrangements and resources for resolution of disputes between customers and members, and between members.

*Core Principle 8—System Safeguards. An Adequate Program of Oversight and Risk Analysis to Ensure That Its Automated Systems Function Properly and have Adequate Capacity, Security, and Emergency and Disaster Recovery Procedures*

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

1. Oversight/risk analysis program:
  - a. Any program of oversight and risk analysis and whether it addresses appropriate principles for the oversight of

automated systems to ensure that its clearing system functions properly and has adequate capacity and security;

- b. Emergency procedures and a plan for disaster recovery; and
- c. Periodic testing of back-up facilities and ability to ensure daily 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; and
- b. Confirmation that such testing and review would be performed by an independent third-party professional that is a certified member of the Information Systems Audit and Control Association with an appropriate level of experience in the industry.

*Core Principle 9—Governance. Have 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 Have a Means to Address Conflicts of Interest in Making Decisions*

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

1. Appropriate 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.
2. Collection and verification of information supporting compliance with standards:
  - a. 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.

*Core Principle 10—Reporting. Provision to the Commission of all Information Necessary for the Commission to Conduct its Oversight Function of the Recognized Clearing Organization's Activities*

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

1. Information necessary for the Commission to perform its oversight activities of the recognized clearing organization's activities:
  - a. All information available to or generated by the clearing organization that will be made available to the Commission 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 means by which any information will be made available to members/participants and/or the general public.

*Core Principle 11—Recordkeeping. Maintaining Complete Books and Records of all Activities Related to Business as a Recognized Clearing Organization in a Form and Manner Acceptable to the Commission for a Period of Five Years*

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

1. Maintaining records of all activities related to the function of a clearing organization:
  - 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. Maintenance of full books and records in a form and manner acceptable to the Commission:
3. How the entity would satisfy the requirements of Commission Regulation 1.31 including:
  - a. What "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 ultimately be maintained (and confirmation that, in any event, they would be maintained for at least five years).

*Core Principle 12—Public Information. Disclosure of Information Concerning the Rules and Operating Procedures Governing its Clearing and Settlement Systems, Including Default Procedures*

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

1. 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. Entering Into and Abiding by the Terms of all Appropriate and Applicable Domestic and International Information-Sharing Agreements and Using Relevant Information Obtained from such Agreements in Carrying out the Recognized Clearing Organization's Risk Management Program*

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

1. Becoming a party to applicable appropriate domestic and international information-sharing agreements and arrangements:
  - a. The utility of entering into various types of information-sharing arrangements;
  - b. 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; and
  - c. The specific information-sharing agreements or other arrangements to which the clearing organization would become a party and how it would abide by the terms of these agreements.
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. Endeavoring to Avoid Unreasonable Restraints of Trade or Imposing Any Burden on Competition not Necessary or Appropriate in Furtherance of the Objectives of the Act or the Regulations Thereunder*

In addressing core principle 14, applicants should describe or otherwise document:

1. Avoiding unreasonable restraints of trade:
  - a. Terms and conditions of access and provision of services;
  - b. Any contracts or agreements to which the organization is a party which contain any noncompete clauses or limitations on future activity which may compete with the interests of either party to the contract.
2. Avoiding burdening competition:
  - a. Any practice of the clearing organization that may appear to affect the competitiveness of any other entity or the practice of any entity that may appear to affect the competitive ability of the clearing organization; and
  - b. The extent to which the entity has endeavored to adopt a rule or practice that is the least anticompetitive means of achieving the objective, purposes and policies of the Act.

Issued in Washington, D.C. on June 8, 2000, by the Commission.

**Jean A. Webb,**  
Secretary of the Commission.

[FR Doc. 00-14916 Filed 6-21-00; 8:45 am]

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## COMMODITY FUTURES TRADING COMMISSION

### 17 CFR Part 35

RIN 3038-AB58

#### Exemption for Bilateral Transactions

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Proposed Rulemaking.

**SUMMARY:** The Commodity Futures Trading Commission (Commission or CFTC) is proposing to clarify the operation of the current swaps exemption, 17 CFR Part 35. In addition, in a companion notice of proposed rulemaking on clearing, the Commission is proposing rules clarifying that transactions under its Part 35 swaps exemption can be cleared. The Commission, in companion releases published in this edition of the **Federal Register**, also is proposing a new regulatory framework to apply to multilateral transaction execution facilities, to market intermediaries and to clearing organizations. This new framework establishes a number of new market categories, including a category of exempt multilateral transaction execution facility. 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.

**DATES:** Comments must be received by August 7, 2000.

**ADDRESSES:** Comments should be sent to the Commodity Futures Trading Commission, Three Lafayette Centre, 1125 21st Street, NW., Washington, DC 20581, attention: Office of the Secretariat. Comments may be sent by facsimile transmission to (202) 418-5521 or, by e-mail to secretary@cftc.gov. Reference should be made to "Exemption for Bilateral Transactions." **FOR FURTHER INFORMATION CONTACT:** Paul M. Architzel, Chief Counsel, Division of Economic Analysis, Commodity Futures Trading Commission, Three Lafayette Centre, 1125 21st Street, NW, Washington, DC 20581. Telephone: (202) 418-5260. E-mail: [PArchitzel@cftc.gov].

**SUPPLEMENTARY INFORMATION:**

## I. Background

The Commission is proposing to amend its Part 35 exemption to expand and to clarify its operation, including the availability of clearing for these transactions. These proposed amendments would provide greater legal certainty to the OTC markets and reduce systemic risk. The Commission was encouraged in this undertaking by the other Federal financial regulators that comprise the President's Working Group on Financial Markets<sup>1</sup> and by the chairmen of the Commission's Congressional oversight committees.

The proposed amendments to part 35 respond to changes that have occurred in the over-the-counter (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 \$80 trillion. OTC derivatives have transformed finance, increasing the range of financial products available for managing risk.

## II. Legal Certainty for Bilateral OTC Transactions

The Commission is proposing to amend its part 35 swaps exemption in a number of ways. First, it is proposing to delete 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. This is being proposed to clarify that an instrument's denomination as a "swap" was not, and is not, an independent condition of the exemption. Moreover, as suggested by the PWG Report, the Commission has also proposed to delete the requirement that exempt

transactions not be fungible or standardized and has made clear that insofar that such exempt transactions may be cleared, creditworthiness of the counterparty is not a condition of the exemption. PWG Report at 17-18. In addition, the Commission is proposing, 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.

The Commission has proposed these changes to its part 35 swaps exemption in order to enhance the legal certainty for such instruments. These changes would in no way call into question any transaction undertaken under the part 35 rules as currently drafted. Moreover, in recognition of its continuing vitality and to assist the public in locating it, the Commission is proposing to incorporate by reference its 1989 Swaps Policy Statement as Appendix A to part 35.<sup>2</sup> Moreover, the Commission is not proposing any changes to its energy interpretation (55 FR 39188) and energy exemption (58 FR 21286) and affirms their continued applicability.

A condition of the part 35 exemption is that such transactions not be entered into and traded on or through a "multilateral transaction execution facility" (MTEF). The Commission is proposing to define MTEF in amendments to part 36 of its rules included in a companion release published in this edition of the **Federal Register**. The Commission is proposing 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." This definition highlights the essential nature of an MTEF as a place or facility through, or on, which traders have the ability to execute agreements or contracts. It does not, however, require that every trader have access to every transaction offered through the facility. The 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." See, 58 FR 5587, 5591 (Jan. 22, 1993). Accordingly, the proposed 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 party offers to enter into bilateral transactions with multiple counterparties who may not transact with each other.

As proposed, the Commission would not make 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.<sup>3</sup>

## III. Section 4(c) Findings

These proposed rule amendments are being proposed 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. To grant such an exemption, the Commission must find that the exemption would be consistent with the public interest, 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.<sup>4</sup>

As explained above, the proposed exemption for bilateral transactions is available only to appropriate persons. Moreover, these amendments to part 35 will promote financial innovation 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. The Commission specifically

<sup>1</sup> Recognizing the importance of the OTC derivatives markets, the Chairmen of the Senate and House Agriculture Committees requested that the President's Working Group on Financial Markets (PWG) 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 Derivative 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.

<sup>2</sup> The Swaps Policy Statement is found at 54 FR 30694 (July 21, 1989).

<sup>3</sup> H.R. Rep. No. 978, 102d Cong., 2d Sess. 82-83 (1992).

<sup>4</sup> See 7 U.S.C. 6(c).

requests the public to comment on these findings.

#### 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. Information of the type that would be required under the proposed rule does not involve any small organizations.

##### B. Paperwork Reduction Act

The Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3507(d)), which 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 does not apply to this rule. The Commission believes the proposed amendments to this rule do not contain information collection requirements which require the approval of the Office of Management and Budget. The purpose of these proposed rule amendments is to provide greater legal certainty for the specified OTC transactions.

##### 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, 4(c), and 8a thereof, 7 U.S.C. 2, 6, 6c, and 12a, the Commission hereby proposes to amend Chapter I, Part 35 of Title 17 of the Code of Federal Regulations as follows:

#### PART 35—EXEMPTION OF BILATERAL AGREEMENTS

1. The authority citation for Part 35 continues to read as follows:

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

2. The heading of part 35 is proposed to be revised as set forth above.

3. Section 35.1 is proposed to be amended by revising paragraph (b) to read as follows:

##### § 35.1 Scope and definitions.

\* \* \* \* \*

(b) *Definition.* As used in this part, “eligible participant” means, and shall be limited to, the following persons or classes of persons:

(1) A bank or trust company (acting on its own behalf or on behalf of another eligible participant);

(2) A savings association or credit union;

(3) 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;

(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 agreement are guaranteed or otherwise supported by a letter of credit or keepwell, support, or other agreement by any such entity referenced in this paragraph (b)(6)(i) 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, acting on its own behalf or on behalf of another eligible participant: 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, acting on its own behalf or on behalf of another eligible participant: 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.

4. Section 35.2 is proposed to be revised to read as follows:

##### § 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 agreement, 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;

(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) Except for those contracts, agreements or transactions submitted for clearance or settlement to a clearinghouse as provided under paragraph (d)(3) of this section, the creditworthiness of any party having an actual or potential obligation under the contract, agreement or transaction would be a material consideration in entering into or determining the terms of the contract, agreement or transaction, including pricing, cost, or credit enhancement terms.

(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 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 resulting from such contracts, agreements or transactions;

(3) The submission of such contracts, agreements or transactions for clearance and/or settlement to a clearing organization which is authorized under § 39.2 of this chapter; or

(4) 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.

5. Section 35.3 is proposed to be added to read as follows:

### § 35.3 Enforceability.

(a) Notwithstanding the exemption in § 35.2, sections 2(a)(1)(B), 4b, and 4c 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 an eligible participant (or counterparty reasonably believed by such party to be an eligible counterparty) 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 or from the terms or conditions of the Statement of Policy Concerning Swap Transactions in appendix A to this part 35.

(c) A party to a contract, agreement or transaction that qualifies under the

Statement of Policy Concerning Swap Transactions in appendix A to this part 35 or the Statutory Interpretation Concerning 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 any provision of the Act or Commission rules, 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.

6. Part 35 is proposed to be amended by adding new Appendix A to read as follows:

### 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.<sup>1</sup> In several

<sup>1</sup> 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

recent releases<sup>2</sup> and in response to requests for case-by-case review of various proposed offerings,<sup>3</sup> 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 herein.

(January 11, 1989) (Proposed Rules Concerning Regulation of Hybrid Instruments); Final Rules Concerning Regulation of Hybrid Instruments, published elsewhere in this issue.

<sup>2</sup> 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).

<sup>3</sup> 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 Com. 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).

*(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."<sup>4</sup> Such an assessment entails a review of the "overall effect" of the transaction as well as a determination as to "what the parties intended."<sup>5</sup> 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.<sup>6</sup> 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.<sup>7</sup> These additional elements facilitate the trading of futures contracts on exchanges and historically have developed in conjunction with the growth of organized contract markets. The presence or absence of these additional elements, however, is not

<sup>4</sup> *CFTC v. Co. Petro Marketing Group, Inc.*, 680 F.2d 573, 581 (9th Cir. 1982).

<sup>5</sup> *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)].

<sup>6</sup> 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.

<sup>7</sup> E.g., Advance Notice, 52 FR at 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).

dispositive of whether a transaction is a futures contract.<sup>8</sup>

(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).<sup>9</sup> 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.<sup>10</sup> Market participants also have noted that swaps typically involve long-term contracts, with maturities ranging up to twelve years.<sup>11</sup> 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

<sup>8</sup> 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).

<sup>9</sup> 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.

<sup>10</sup> 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.

<sup>11</sup> 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.

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 below 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,<sup>12</sup> the Treasury Amendment,<sup>13</sup> and the trade option exemption,<sup>14</sup> 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 herein and may encompass certain swap transactions.<sup>15</sup>

<sup>12</sup> 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.

<sup>13</sup> 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.

<sup>14</sup> 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.

<sup>15</sup> The forward contract inclusion facilitates commodity transactions within the commercial

Continued

(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 below 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.<sup>16</sup>

(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.<sup>17</sup> 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 may be terminated by offset,<sup>18</sup> that

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.

<sup>16</sup> 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 herein apply equally to options on swaps.

<sup>17</sup> 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.

<sup>18</sup> 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'

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.<sup>19</sup>

(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: (1) 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 (2) 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.<sup>20</sup> 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.

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.

<sup>19</sup> However, the ability to liquidate contractual positions through offset is established by clearing organization rules to which all clearing members consent.

<sup>20</sup> Swap parties may agree in advance upon a termination formula or price for the swap.

(iii) Absence of Clearing Organization or Margin System

(A) As noted above, 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 market-to-market margin and variation settlement system designed to eliminate individualized credit risk.<sup>21</sup> 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 above criteria would not be affected.

(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.<sup>22</sup>

(B) The safe harbor set forth herein is limited to swap transactions undertaken in conjunction with the parties' line of business.<sup>23</sup> 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

<sup>21</sup> 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.

<sup>22</sup> Letter dated April 8, 1988, to CFTC from International Swap Dealers Association, Inc. Concerning Advance Notice.

<sup>23</sup> 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.

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 above criteria and that are not otherwise excluded from Commission regulation.

Issued in Washington, D.C., this 8th day of June, 2000, by the Commission.

**Jean A. Webb,**

*Secretary of the Commission.*

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## COMMODITY FUTURES TRADING COMMISSION

**17 CFR Parts 1, 3, 4, 5, 15, 20, 36, 37, 38, 39, 100, 140, 155, 166, 170, and 180**

### A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Notice of public meetings.

**SUMMARY:** Notice is hereby given that the Commodity Futures Trading Commission ("Commission") will convene two public meetings at which interested members of the public may appear before it to give oral and written statements relating to the Commission's consideration of a new regulatory framework for multilateral transaction execution facilities, intermediaries and clearing organizations.

**DATES:** Tuesday, June 27, 2000, 10:00 a.m.-4:00 p.m. (multilateral transaction execution facilities); Wednesday, June 28, 2000, 10:00 a.m.-4:00 p.m. (intermediaries and clearing organizations).

**PLACE:** 1155 21st St., N.W., Washington, D.C. Lobby Level Hearing Room located at Room 1000. Status: Open.

**ADDRESSES:** Requests to appear and statements of interest should be mailed to the Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, D.C. 20581, attention Office of the Secretariat; transmitted by facsimile at (202) 418-5521; or transmitted

electronically to [secretary@cftc.gov]. Reference should be made to "Regulatory Reinvention Meetings."

**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, N.W., Washington, D.C. 20581, (202) 418-5260, or electronically, [PArchitzel@cftc.gov] or [NYanofsky@cftc.gov].

**SUPPLEMENTARY INFORMATION:** In separate **Federal Register** releases published today, the Commission has proposed a new regulatory framework to apply to multilateral transaction execution facilities that trade derivatives, market intermediaries and clearing organizations. As explained in those **Federal Register** releases, the proposed framework contemplates far reaching and fundamental changes to modernize Federal regulation of the commodity futures and options markets.

The Commission is of the view that, in addition to the receipt of written comments, an opportunity for interested members of the public to appear before it will assist it in its consideration of the issues raised in the **Federal Register** releases and is in the public interest. Accordingly, the Commission will convene two public meetings, one on Tuesday, June 27, 2000 from 10:00 a.m. to 4:00 p.m. relating to the proposed framework as it applies to multilateral transaction execution facilities and one on Wednesday, June 28, 2000 from 10:00 a.m. to 4:00 p.m. relating to the proposed framework as it applies to market intermediaries and clearing organizations.

All individuals or organizations wishing to appear before the Commission should submit to the Commission at the above address, by June 23, 2000, a request to appear at either or both of the meetings, a concise statement of interest and qualifications as they relate to the particular meeting(s) and a brief summary or abstract of the content of his or her statement(s). The Commission will invite a representative number of individuals or organizations to appear at each meeting from those submitting such statements. A transcription of the meetings will be made and entered into the Commission's public comment files, which will remain open for the receipt

of written comment until August 7, 2000.

Issued in Washington, D.C., this 8th day of June 2000.

By the Commodity Futures Trading Commission.

**Jean A. Webb,**

*Secretary of the Commission.*

### Concurring Statement of Commissioner Thomas J. Erickson

I concur with the Commission's publication of this Notice of Public Hearing as well as with the simultaneous publication of the related proposed rulemakings entitled (1) Exemption for Bilateral Transactions; (2) A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations; (3) A New Regulatory Framework for Clearing Organizations; and (4) Rules Relating to Intermediaries of Commodity Interest Transactions.

Global derivatives markets are changing at a dramatic pace. Today's **Federal Register** releases represent an equally dramatic effort by Commission staff to modernize our regulatory scheme by accommodating new technologies and providing exchanges with some measure of regulatory relief.

Accordingly, I agree with the publication of this and each related release and am hopeful that they will stir considerable thought and comment. With this concurrence—and in addition to the specific requests for comment in the proposed rules—I invite comment on certain aspects of this plan about which I have reservations. Specifically:

- Does the plan promote legal certainty for transactions by providing a regime that is based upon the voluntary submission of certain derivatives markets to Commission regulation?

- Are there enforceability and/or compliance concerns associated with a regulatory regime based on "broad performance standards" incorporated as core principles?

- Does the plan take adequate account of the public's interest in the Commission's ability to:

- Deter and detect fraud and manipulation?

- Deter and detect abusive trading practices?

- Ensure the financial integrity of industry participants?

I look forward to receiving comment and testimony that touch upon a full range of issues in addition to those few I have mentioned in this concurrence.

Dated: June 6, 2000.

**Thomas J. Erickson,**

*Commissioner.*

[FR Doc. 00-14918 Filed 6-21-00; 8:45 am]

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