<u>Exempt Commercial Markets</u>

I. The CFMA's Tiered Approach

The CFMA established a tiered approach to regulatory oversight of derivatives markets. Each tier is subject to a varying level of regulation based on the concerns raised by that market. Separate from the degree of regulatory oversight, however, the Commission has jurisdiction to ensure that all markets are in compliance with exclusion, exemption and designation criteria. Factors that determine which tier a market falls into include: (1) the nature of the participant (how sophisticated); (2) the nature of the commodity (how susceptible to manipulation); (3) whether the market is intermediated; and (4) the trading mechanism (*e.g*. individually negotiated vs. bids and offers open to multiple counterparties).

Listed below are the types of derivatives markets in order from least to most regulated tier:

- <u>Excluded Markets</u> (sections 2(d), 2(e), 2(f) and 2(g) of the CEA)
  - No CFTC oversight authority; exclusion is entirely self-executing and there is no initial or ongoing reporting requirement with the Commission
  - Markets must allow trading only by ECPs/sophisticated professionals, usually trading bilaterally
  - Limited to certain types of products e.g., "excluded commodities" (mostly financial products)
  - Trades must be either bilateral or on an electronic trading platform

- <u>Transactions in Exempt Commodities not entered into on a Trading Facility</u> (section 2(h)(1) of the CEA)
  - No CFTC oversight authority; <u>no</u> notification of operation to the Commission is required
  - Transactions cannot be entered into on a trading facility and must be conducted only by ECPs
  - Anti-manipulation authority and limited anti-fraud authority

- <u>Exempt Markets</u> (sections 2(h)(3)-(5) and 5d of the CEA)
  - Very limited CFTC oversight authority; markets must <u>notify</u> the Commission of operation;
  - CFTC has anti-fraud and anti-manipulation authority; but the Commission's tools for monitoring markets directly for such violations are generally limited to our authority to issue special calls.
  - Part 36 regulations cover filing standards, access and price discovery matters.
  - Types of Exempt Markets:
    - *Exempt Boards of Trade* ("EBOT" or "EXBOT") (section 5d of the CEA)– Markets may only list certain "excluded commodities" (or certain other commodities as the Commission may determine) for trading, only by ECPs.
    - *Exempt Commercial Markets* ("ECM") (section 2(h)(3)-(5) of the CEA - described in detail below

- Derivatives Transaction Execution Facilities ("DTEF") (section 5a of the CEA)
    - CFTC oversight authority as a regulated exchange; need to comply with limited registration criteria and core principles, and provide information in limited circumstances
    - Part 37 regulations;
    - Types of DTEFs:
        - *"Retail DTEFs"* may only list excluded commodities.
            - Are available to: 1) institutional traders (ECPs) or 2) non-institutional traders (non-ECPs, e.g. retail traders) that trade through FCMs having at least $20 million in net capital.
        - "*Commercial DTEFs*" Futures and option contracts on any commodity other than the agricultural commodities may be listed for trading and are available only to eligible commercial entities trading for their own account.
    - No entities have been registered as, or have applied to be, a DTEF.

- Designated Contract Markets ("DCM") (section 5 of the CEA)
    - CFTC oversight authority as a regulated exchange, need to comply with comprehensive designation criteria and core principles and provide information on a broad scale
    - Part 38 regulations,
    - Can allow access to all types of traders, including retail customers; can permit intermediation; and may list for trading futures or option contracts based on all types of products.
    - DCMs are the traditional futures exchanges.

II. Exempt Commercial Market (ECM) Statutory Requirements - §2(h)(3)-(5)

- Participants Eligible Commercial Entities (ECEs)
- Commodities Exempt Commodities (e.g., metals, chemicals, energy products, pollution allowances, wood pulp, etc.)
- Intermediation Not permitted; principal to principal trades only
- Platform Electronic Trading Facility

- ECM Requirements:

    - ECMs must:
        - Notify the Commission of intent to operate as an ECM, identifying:
            - name and address of the facility and a contact person
            - commodity "categories" the facility intends to trade
            - any derivatives clearing organization facility used for clearance and settlement
        - Certify certain information regarding fitness, compliance and updates
        - Keep certain records and allow Commission inspection

        - Provide Commission with access to trading protocols and electronic access to the facility or provide such reports as the Commission may request (discussed below)
        - Comply with requirements of the exemption and require that its participants agree to comply with all applicable law as a condition of trading on the ECM
        - Have a reasonable basis for believing that participants authorized to conduct transactions on the facility are "eligible commercial entities"

    - ECMs are:
        - Subject to a limited <u>price discovery</u> requirement (see regulatory requirements below)
        - Subject to <u>special calls</u> by the Commission to provide information, in a form and manner and within the period specified in the special call, related to the business of the ECM, including information relating to data entry and transaction details, in order to (i) enforce the Act's anti-fraud and anti-manipulation provisions , (ii) evaluate a systemic market event, or (iii) obtain information requested by a federal financial regulatory authority in order for that authority to fulfill its regulatory or supervisory responsibilities.
        - Prohibited from claiming that they are registered with, or recognized, designated, licensed or approved by the Commission
        - Not <u>themselves</u> exempted from the Act, instead <u>transactions</u> are exempt when the transaction meets the requirements of CEA section 2(h)(3). A failure by the ECM to limit such trading or to comply with the section 2(h)(5) requirements will not in itself affect the transactions entered or the participants trading on the facility.

- <u>Anti-fraud and anti-manipulation</u>. Transactions on an ECM are subject to the anti-fraud and anti-manipulation provisions of the Act.

    - <u>Anti-manipulation</u>: The anti-manipulation provision does not include active surveillance of ECMs because the CFTC cannot impose its Large Trader Reporting System on ECMs. Instead, the Commission is limited to using special call authority.
    - <u>Anti-fraud</u>: The language of Section 4b, coupled with the requirement that transactions on ECMs be entered by ECEs on a "principal-to-principal basis"—may create uncertainty with respect to the Commission's antifraud authority in the context of ECMs. In *Commodity Trend Service, Inc.*, a pre-CFMA case, the Seventh Circuit Court of Appeals held that Section 4b applies only to fraud by brokers and other persons who have an agency relationship with their clients based on the phrase "for or on behalf of any other person," which is part of the introductory language of Section 4b(a). This interpretation has not been adopted by other courts and the Commission has continued to bring 4b claims in principal-to-principal transactions involving retail customers. In addition, there is legislative history that

indicates that Congress intended our 4b authority to apply to ECMs. Senator Lugar's remarks on the CFMA in the Congressional Record: "Section 4b provides the CFTC with broad authority to police fraudulent conduct within its jurisdiction, whether occurring in boiler rooms and bucket shops, or in the **e-commerce and other markets** that will develop under the new statutory framework" (emphasis added).

- CFTC Rulemaking Authority. The CEA clearly allows the Commission to issue rules and regulations regarding ECMs: (1) concerning administrative implementation of the Act's provisions; and (2) requiring the timely dissemination of trading data upon a CFTC determination that the ECM performs a significant price discovery function for transactions in the cash market for the commodity underlying any agreement, contract, or transaction executed or traded on the ECM. (The CFTC also has authority to issue rules, regulations or orders regarding procedures to be followed when a foreign person requests a hearing concerning a CFTC-issued subpoena regarding ECM transactions.)

III. Exempt Commercial Market Regulatory Requirements – Section 36.3

- Section 36.3 implements the statutory requirements with specific procedures regarding administrative, information access and price discovery requirements.

    - Administrative – Sets forth the details of notification to the Commission
    - Information Access – Requires the ECM to identify those transactions conducted on the facility in reliance on the 2(h)(3) exemption and which averaged 5 trades per day or more over the most recent quarter. With respect to such trades, it must either:
        - *Report* - submit a weekly report to the Commission of individual transaction data (commodity, location, maturity date, price, quantity, etc.) for transactions in contracts which rely upon the 2(h)(3) exemption and which meet a five trade per day threshold test, or
        - *Grant Access* – Requires the ECM to provide the Commission with electronic access to transactions on the facility conducted in reliance on 2(h)(3) and meeting the five trades per day test that would allow the CFTC to compile the same information
    - Price Discovery – If an ECM performs a significant price discovery function for transactions in the cash market for the underlying commodity **a reporting requirement is triggered but not oversight authority**. The ECM must disseminate publicly and on a daily basis, specific information with respect to the transactions executed in reliance on the exemption (contract terms and conditions, trading volume, open interest if available, opening and closing prices, etc). An ECM performs a significant price discovery function for transactions in an underlying cash market commodity when:
        - cash market bids, offers or transactions are directly based on or quoted at a differential to, the prices generated on the ECM on a more than occasional basis or

    - the ECM's prices are routinely disseminated in a widely distributed industry publication and are routinely consulted by industry participants in pricing cash market transactions.
- □ Annual notification - Certification, no later than the end of each calendar year, that the market continues to operate pursuant to its original notification (effective 2/13/06)
- □ Customer Complaints - ECMs are required to maintain a record of allegations or complaints of instances of suspected fraud or manipulation on the facility and to provide the Commission with a copy of the record of each complaint that alleges facts constituting a violation of the Act or CFTC regulations within 30 days of receipt, provided that a complaint alleging an ongoing fraud or manipulation must be reported within three business days after receipt of the complaint.
- □ Required representation – ECMs must represent, in their notification to the Commission, that they require participants to comply with all applicable law and must have a reasonable basis for believing all participants are "eligible commercial entities."