

**COMMODITY FUTURES TRADING COMMISSION**

**17 CFR Parts 1, 5, 15, 36, 37, 38, 40, 41, 100, 166, 170 and 180**

**RIN 3038-AB63**

A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Final rulemaking.

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**SUMMARY:** The Commodity Futures Trading Commission (Commission or CFTC) is promulgating final rules to implement those provisions of the Commodity Futures Modernization Act of 2000 (CFMA) relating to trading facilities. The CFMA profoundly altered federal regulation of commodity futures and option markets. The new statutory framework establishes two categories of markets subject to Commission regulatory oversight, designated contract markets and registered derivatives transaction execution facilities, and two categories of exempt markets, exempt boards of trade and exempt commercial markets. These rules establish administrative procedures necessary to implement the CFMA, interpret certain of the CFMA's provisions and provide guidance on compliance with various of its requirements. In addition, the Commission, under its exemptive authority, in a limited number of instances is providing relief from, or greater flexibility than, the CFMA's provisions.

Rules implementing the CFMA relating to clearing organizations were recently proposed in a separate notice of proposed rulemaking (66 FR 24308 (May 14, 2001)), and rules pertaining to intermediaries which were previously withdrawn will be repropose at a later time.

**EFFECTIVE DATE:** [insert date 60 days from publication in the Federal Register].

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**SUPPLEMENTARY INFORMATION:**

**I. Background**

**A. Overview**

The Commission on June 22, 2000, proposed (65 FR 38986) and on December 13, 2000, issued (65 FR 77962) final rules promulgating a new regulatory framework to apply to multilateral transaction execution facilities that trade contracts of sale of a commodity for future delivery or commodity options.<sup>1</sup> The final rules were to become effective on February 12, 2001.

Before the Commission's new regulatory framework became effective, however, Congress on December 15, 2000, passed, and President Clinton on December 21, 2000, signed into law, the Commodity Futures Modernization Act of 2000 (CFMA)<sup>2</sup>, which substantially amended the Commodity Exchange Act, 7 U.S.C. 1 et seq. (Act). The Act, as amended by the

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<sup>1</sup> See also Rules Relating to Intermediaries of Commodity Interest Transactions, 65 FR 77993 (Dec. 13, 2000), and A New Regulatory Framework for Clearing Organizations, 65 FR 78020 (Dec. 13, 2000). These three related rule packages in their entirety constituted the Commission's new regulatory framework.

<sup>2</sup> P.L. 106-554, \_\_ Stat. \_\_

CFMA, establishes two tiers of regulated markets, designated contract markets (contract markets) and registered derivatives transaction execution facilities (DTFs). In addition, the Act, as amended, provides for two categories of markets exempt from regulation, exempt boards of trade and exempt commercial markets.

The CFMA, in both its broad contours and in many of its specific provisions, codified the Commission's new regulatory framework without significant change. However, it varied from the rules implementing the framework in a number of details and rendered unnecessary a number of those rules by enacting their provisions into law. The Commission, therefore, withdrew most of the final rules in order to determine their consistency with the Act as amended.<sup>3</sup> 65 FR 82272. On March 9, 2001, the Commission proposed new rules conforming to and implementing the amended statutory scheme with respect to transaction execution facilities. 66 FR 14262.<sup>4</sup>

## **B. The Proposed Rules**

The Commission proposed a new part 38 relating to contract markets that, as proposed, would exempt contract markets operating under part 38 from all Commission rules not

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<sup>3</sup> The Commission determined not to withdraw rules concerning the investment of customer funds, but rather moved forward their effective date to December 28, 2000. See 65 FR 82270 (Dec. 28, 2000).

<sup>4</sup> The Commission separately proposed rules implementing the CFMA with respect to Commission-regulated derivatives clearing organizations. 66 FR 24308 (May 14, 2001). Implementation of the CFMA also requires the Commission to undertake a number of rulemakings in addition to those that were part of the Commission's new regulatory framework, such as rules relating to security futures products. Those rulemaking proceedings are separate from the rules being adopted herein. Finally, rules relating to intermediaries that were included in the new regulatory framework withdrawn in December, but which are not required by the CFMA, will be repropounded by the Commission at a later date.

specifically reserved.<sup>5</sup> Part 38 also proposed application and approval procedures for new contract markets, including a 60-day fast-track approval procedure as well as procedures for product listing and amendments. Proposed part 38 also contained a number of rules explaining the Commission's interpretation of several statutory requirements.

Proposed part 37 construed section 5a of the Act, which provides for registration of DTFs. The proposed rules identified the commodities eligible to be traded on a DTF as a matter of right under section 5a(b)(2)(A) through (C) of the Act, as those defined as "excluded" commodities in section 1a(13) of the Act.<sup>6</sup> Part 37 also proposed a procedure under which a specific DTF could petition to list contracts on additional commodities. The Commission also proposed a number of provisions providing greater administrative flexibility in the registration<sup>7</sup> and oversight of DTFs than provided for in the Act, as amended. Proposed appendices to parts 37 and 38 provided general guidance for complying with the rules.

The Commission also proposed a new part 36 relating to exempt boards of trade and exempt commercial markets. Transactions entered into by eligible commercial entities in exempt commodities<sup>8</sup> traded on an electronic trading facility, are exempt commercial markets

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<sup>5</sup> It should be noted that rules that are not being reserved with respect to their application to contract markets (or DTFs) will still apply to intermediaries, clearing organizations, and contract market members, if relevant to those entities. See, e.g., Commission rule 1.35.

<sup>6</sup> Section 1a(13) of the Act defines an "excluded commodity" to mean, among other things, an interest rate, exchange rate, currency, credit risk or measure, debt instrument, measure of inflation, or other macroeconomic index or measure.

<sup>7</sup> As proposed, existing contract markets need only notify the Commission of their intent to operate as a DTF, and file with the Commission the DTF's rules and a certification that they meet all of the requirements for registration as a DTF.

<sup>8</sup> See section 1a(14) of the Act.

under section 2(h)(3) of the Act.<sup>9</sup> Markets that satisfy the initial and ongoing requirements of sections 2(h)(3) through (5) of the Act, as amended, are excluded from the Act's other requirements. The Commission proposed rules in part 36 to implement the notification requirements of section 2(h)(5)(A) of the Act, and the information requirements for exempt commercial markets consistent with section 2(h)(5)(B) of the Act.

In part 36, the Commission also proposed rules implementing Section 5d of the Act, which establishes the category of “exempt board of trade.” Commission rule 36.2 proposed to define those commodities that are eligible to trade on an exempt board of trade to include commodities defined in section 1a(13) of the Act as “excluded commodities,” other than securities, and such other commodities as the Commission may define by rule, regulation or order. In addition, rule 36.2(b) proposed the form and manner of the notification to the Commission provided for under section 5d of the Act.

The Commission also proposed an antifraud provision, proposed rule 1.1, pursuant to its authority in sections 3 and 8a(5) of the Act. This proposed anti-fraud rule would apply to foreign currency transactions described in section 2(c)(1) of the Act.

Finally, the Commission proposed to delete Part 180 of its rules governing arbitration of disputes arising on contract markets, and repropose its withdrawn rule 166.5, incorporating the

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<sup>9</sup> See sections 2(e)(1) and 2(h)(3) of the Act, as added by sections 104 and 106 of the CFMA. The Act refers to electronic commercial markets as “excluded” from the Act's regulatory requirements that are not qualifying conditions for the exemption. These qualifying conditions are found in paragraphs 2(h)(4) and (5). Moreover, it should be noted that among these qualifying conditions, the Commission is authorized to promulgate rules to ensure disclosure of prices and to specify procedures regarding redress by participants to an order denying them

new provision added by the CFMA, which permits an FCM to require an eligible contract participant to waive the right to reparations as a condition of using the FCM's services.

### **C. Overview of Comments**

The Commission received a total of 20 comments<sup>10</sup> from a range of commenters, including a government agency, an association of state securities regulators, a self-regulatory organization,<sup>11</sup> five futures exchanges,<sup>12</sup> a derivatives clearing organization,<sup>13</sup> eight trade associations,<sup>14</sup> a trading firm, an attorney and a group of energy firms.<sup>15</sup>

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access in response to a determination that the participant did not comply with a subpoena issued by the Commission. See sections 2(h)(4)(D), 2(h)(5)(C)(ii) and 2(h)(6) of the Act.

<sup>10</sup> In this Notice of Final Rulemaking, comment letters (CL) are referenced by the letter's file number and page. These letters are available through the Commission's internet web site, <http://www.cftc.gov>.

<sup>11</sup> They are: United States Department of the Treasury (Treasury)(CL 14), North American Securities Administrators Association, Inc. (NASAA)(CL 2), and National Futures Association (NFA)(CL 16), respectively.

<sup>12</sup> They are: Board of Trade of the City of New York, Inc. (NYBOT)(CL 5), Chicago Board of Trade (CBT)(CL 7), New York Mercantile Exchange (NYMEX)(CL 10), Minneapolis Grain Exchange (MGE)(CL 15), and Chicago Mercantile Exchange (CME)(CL 18).

<sup>13</sup> Board of Trade Clearing Corporation (BOTCC)(CL 1).

<sup>14</sup> They are: International Swaps and Derivatives Association, Inc. (ISDA)( CL 3), @Markets (CL 6), National Grain and Feed Association (NGFA)(CL 9), Futures Industry Association (FIA) (CL 11), Silver Users Association (SUA) (CL 12), National Grain Trade Council (NGTC)(CL 17), Association of the Bar of the City of New York (NY Bar)(CL 19) and Securities Industry Association (SIA)(CL 20).

<sup>15</sup> They are: Advance Trading, Inc. (CL 13), Thomas Muth, Esq. (CL 8), and Energy Group (CL 4), respectively.

In addition to the written comments, the proposed rules were discussed at a March 28, 2001, meeting of the Commission's Agricultural Advisory Committee (AAC), chaired by Commissioner David D. Spears. A transcript of the AAC meeting is also included in the Commission's comment file and is available on the Commission's website.

Most commenters generally supported the proposed rules, especially those provisions that offered greater flexibility than provided by the CFMA. Commenters also expressed support for the guidance regarding compliance with the core principles applicable to contract markets and DTFs. Many commenters offered specific recommendations for clarification of the rules or requested that the Commission clarify how the rules would be applied in specific circumstances.

## **II. The Final Rules.**

### **A. Part 38—Contract Markets**

Part 38 governs trading on designated contract markets. Under rule 38.2, contract markets operating under this part are exempt from all Commission rules not specifically reserved. Rule 38.3 contains application and approval procedures for new contract markets, including a 60-day fast-track approval procedure. The designation procedures, which include Commission authority to designate a contract market upon conditions, require applicants to (1) demonstrate that they satisfy the criteria for designation under section 5(b) of the Act and the core principles for operation under section 5(d) of the Act; (2) include a copy of the contract market's rules; and (3) provide a brief explanation of how the conditions for designation are satisfied to the extent that compliance with the conditions for designation is not self-evident.

Based upon its experience in processing applications for designation following proposal of these rules,<sup>16</sup> the Commission is modifying final rule 38.3 to make clear that an applicant may

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<sup>16</sup> In its notice of proposed rulemaking, the Commission stated that during the transition period between the effective date of the CFMA and the adoption of final implementing regulations, it would, in effect, permit applications to be filed under the procedures as proposed. 66 FR 14268.

instruct the Commission in writing at the time of application to review the application under the procedures of section 6 of the Act, which provide for approval within 180 days, rather than under the rule's fast-track review procedures. This is different than the proposed rule, which provided that an applicant could instruct the Commission in writing "during the review period" to review the application under the statutory review procedure.<sup>17</sup> Absent such a written instruction, the application will be reviewed under the fast-track procedures, as was proposed.<sup>18</sup>

The Commission is modifying proposed rule 38.4 (also based upon its administrative experience) to provide that the operational rules of an applicant for contract market designation and the terms or conditions of any products to be listed for trading that have been filed for voluntary Commission approval with the application or while it is pending shall be deemed approved by the Commission no earlier than at the time that the facility itself is deemed to be designated. This proviso has been added to final rule 38.4 to conform the time for review and approval of the rules of an applicant-- in cases where the applicant voluntarily requests Commission approval of its operational or product-related rules--with the review period for the application for contract market designation itself.

In response to a number of comments, proposed rule 38.3(b)(2) is being modified. The rule as proposed would have interpreted the designation requirement on fair and equitable trading to include making available to market participants timely information on prices, bids and

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<sup>17</sup> Two applicants have indicated that they preferred for their applications to be processed more slowly than provided for under the fast-track rules and that the rule explicitly should permit applicants to so indicate at the time the application is filed. The Commission agrees.

<sup>18</sup> The Commission is making a similar clarification to rule 37.5(b)(5), relating to applications for registration as a DTF.

offers. A number of commenters suggested that the proposed requirement be modified to apply in a manner “appropriate to the market.”<sup>19</sup> As the CBT suggested:

while it may be expected that an electronic market would be able to routinely capture and disseminate bids and offers entered into the trading system, as well as execution prices, it is difficult for an open outcry market to do the same.

CL 7-7. See also CL 10-3 and CL 18-3.

The Commission agrees and is modifying the final rule by including the “appropriate to the market” language that it had previously included in the withdrawn rules.<sup>20</sup> Currently, most open-outcry markets generally capture price changes only. By including the “appropriate to the market” language, the Commission intends to make clear that it is not applying to open-outcry markets a standard for disseminating such information that is higher than the one presently in effect. However, the Commission expects that electronic trading systems can, and appropriately will, capture such information for every transaction, not just for those involving a price change.

CBT asked the Commission to clarify application of the core principle on fitness under section 5(d)(14) of the Act. That provision of the Act requires contract markets to apply appropriate fitness standards for “directors, members of any disciplinary committee, members of the contract market, and any other persons with direct access to the facility.” Regarding “direct access,” CBT noted:

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<sup>19</sup> The suggested revision applies equally to proposed rule 37.6(d)(3) relating to DTFs, which has a similar provision.

<sup>20</sup> The Commission also is making conforming changes to Part 38, Appendix A, Criterion 3 and to Part 37, Appendix B, Core Principle 4.

automated order routing systems may enable numerous customers to send their orders directly to a trading floor or to an electronic trading system. Such trades may be intermediated and/or guaranteed by a clearing FCM. The CBOT does not believe that the Commission intended to require markets to impose fitness requirements on such customers.

CL 7-8. See also CL 5-4, CL 19-5.

Generally, the core principles are intended to apply to contract markets (and DTFs) regardless of the form of business organization.<sup>21</sup> Section 5(d)(14) requires persons who exercise governance responsibilities or control of the trading facility to meet a fitness requirement.<sup>22</sup> In a mutually-owned enterprise, members would exercise such governance authority. In a demutualized contract market, the facility's owner or owners would have such authority.<sup>23</sup> CBT correctly observes that customers having direct trading access through an automated order entry routing system or otherwise do not exercise a member's governance authority.<sup>24</sup> The Commission interprets the core principle on fitness under section 5(d)(14) of the Act as not requiring contract markets to establish fitness standards for customers as a consequence of their using direct order routing systems to trade.

NY Bar raised a similar concern, stating that:

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<sup>21</sup> But see section 5(d)(16) of the Act, which unlike the other core principles, applies only to mutually-owned contract markets.

<sup>22</sup> Thus, directors, members of disciplinary committees, and members are required to meet a fitness requirement. Section 1a(24) defines a member as a person "owning or holding membership in . . . the contract market, or having trading privileges on the contract market."

<sup>23</sup> The Commission clarified the core principle's application with respect to demutualized contract markets by making explicit that the core principle on fitness requires a demutualized contract market to establish fitness requirements for all natural persons that directly or indirectly have greater than a ten percent ownership interest in the facility. See proposed rule 38.3(b)(4).

<sup>24</sup> CL 7-8. See also comments of NYBOT, CL 5-4, and NY Bar, CL 19-5.

Appendix A to Part 38 in Designation Criterion 6 states that a contract market must have authority to discipline ‘market participants.’ It should be made clear that this does not apply to customers of members.

CL 19-5. See also CL 5-5.

The Commission does not agree. Designation criterion 6 (Section 5(b)(6) of the Act) provides, in part, that:

a board of trade shall establish and enforce disciplinary procedures that authorize the board of trade to discipline, suspend, or expel members or market participants that violate the rules of the board of trade, or similar methods for performing the same functions.

Contract markets have the authority to deny access to persons who violate their rules, either directly, or indirectly through their members. The Commission also recognizes, however, that a contract market might encounter difficulty in enforcing fines or other sanctions to remedy violations of its rules by persons trading on a market that do not have a significant ownership interest in the facility. Accordingly, the Commission proposed in rule 38.3(b)(3) to make clear “that a trading facility applying for designation may satisfy the requirement that it have disciplinary procedures with respect to non-members by having the capacity to sanction non-member violations by expelling them or by denying them future access.” 66 FR 14263, n. 7. Part 38, Appendix A, reflects rule 38.3(b)(3)’s interpretation of designation criterion 6 that a contract market need only have authority to deny access to such persons.

Nevertheless, the Commission is modifying rule 38.3(b)(3) and Appendix A, in light of NY Bar’s comment, to clarify that the denial of access may be either direct by order to the market participant or indirect by order to contract market members. The Commission is also

clarifying that the capacity to expel or deny access to a member with trading privileges but having no, or only nominal equity interest in the facility, also satisfies the requirements of designation criterion 6. In this regard, the definition of “member” in section 1a(24) of the Act includes persons with trading privileges. Such persons may have trading privileges under a “user agreement” with the facility or trading platform or by virtue of a non-equity “membership” of only nominal value. Levying fines or imposing other types of sanctions against non-equity “members” may be as difficult as imposing such remedies against non-member market participants.<sup>25</sup>

Core principle 4 requires contract markets to monitor trading to prevent manipulation. Part 38, Appendix B, provided that contract markets, as an acceptable practice, should have access to clearing information. BOTCC points out that, because a contract market’s provider of clearing services may be a completely independent entity, the clearing entity should be required to provide such information to a contract market “only in furtherance of the contract market’s self-regulatory responsibilities and only upon a showing of need or other good cause.” CL 1-2. CBT disagreed, reasoning that, “it is crucial to the performance of a contract market’s trade monitoring function that it retains such access without any restrictions or any special showing of need.” CL 7-6; CL 10-3. The Commission agrees that a contract market must be able to obtain such information without limitation. Accordingly, contract markets, by contract, must provide

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<sup>25</sup> NY Bar also suggested that Part 38, Appendix A, clarify that “a contract market is not required to establish minimum financial standards for customers of intermediaries.” The Commission has modified the text by removing the term “user,” based on the understanding that the statutory meaning of “member” includes those only having trading privileges on the facility.

for such unimpeded access to information from third-parties performing clearing functions for the contract market.

NYBOT asked the Commission to modify the guidance for the designation criterion on the financial integrity of transactions. NYBOT argued that contract market rules are not required by the Act and are unnecessary because futures commission merchants continue to be subject to the segregation and related recordkeeping requirements of section 4d of the Act and Commission rules thereunder. CL 5-3. The Commission disagrees. The CFMA specifically requires contract markets (and DTFs) to establish and enforce rules addressing the financial integrity of transactions executed on or through the board of trade or facility.<sup>26</sup>

The Commission anticipates that contract markets will continue to be able to fulfill their self-regulatory responsibilities concerning the financial responsibility of intermediaries through existing mechanisms, including audits conducted by designated self-regulatory organizations. The Commission has clarified this point in Appendix B, in the application guidance to Core Principle 11, and has noted explicitly that, “A contract market may delegate to a designated self-regulatory organization responsibility for receiving financial reports and for conducting

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<sup>26</sup> See Designation Criterion 5 of section 5(b) of the Act, providing that a contract market “shall establish and enforce rules and procedures for ensuring the financial integrity of transactions entered into by or through the facilities of the contract market.” See also section 5a(c) of the Act, Registration Criterion 4, governing the financial integrity of transactions entered into on a DTF. The Commission notes that, in conformance with its notice of proposed rulemaking with respect to clearing, 66 FR 24308, it has modified the guidance for Designation Criterion 5 to reflect that transactions executed on a contract market, if cleared, must be cleared with a derivatives clearing organization registered with the Commission, absent Commission action pursuant to its section 4(c) exemptive authority.

compliance audits pursuant to the guidelines set forth in rule 1.52.” Accordingly, rule 1.52 has been added to the rules reserved under Commission rule 38.2.<sup>27</sup>

## **B. Part 37—DTFs**

New part 37 implements section 5a of the Act, which provides for registration of DTFs. Rule 37.2 exempts DTFs from all Commission regulations applicable to a trading facility that are not reserved,<sup>28</sup> and makes clear that the reserved regulations apply as though DTFs were specifically referenced therein. Rule 37.3 identifies the commodities eligible to be traded on a DTF under section 5a(b)(2)(A) through (C) of the Act as those defined as “excluded” commodities in section 1a(13) of the Act.<sup>29</sup>

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<sup>27</sup> The Commission also has modified Part 38, Appendix A, Designation Criterion 5, and Part 37, Appendix A, Registration Criterion 4, by referring to the form of margin rather than to margin “levels.” In this regard, it should be noted that the Commission is not mandating specific margining systems. Compare CL 18 at 3. In addition, the Commission has made a number of conforming or technical textual changes to Part 38, Appendix B, in response to the comments of MGE, NY Bar, NYBOT, and NYMEX. As modified, Appendix B states explicitly that Core Principle 7, which relates to public disclosure of certain information, may be satisfied through timely placement of the information on the facility’s web site. The language relating to Core Principle 6 (emergency authority) now reads, “minimize the effects of conflicts of interest.” Core Principle 9 has been modified to make clear that the qualified independent professional testing of a system need not be performed by a third-party provider, and the discussion related to Core Principle 10 (trade information) now reads “transaction executed on” rather than “effected on.” The Commission also clarified the discussion of position limits under Core Principle 5 and of trade information under Core Principle 10.

<sup>28</sup> As noted in footnote 5 above, rules that also have application to intermediaries or clearing organizations would still apply to those entities even though they are not being reserved with respect to their application to DTFs.

<sup>29</sup> Section 5a(b)(2)(A) through (C) of the Act, as amended, provides that a DTF may trade any contract of sale of a commodity for future delivery (or option on such a contract) only if—

- (A) the underlying commodity has a nearly inexhaustible deliverable supply;

Rule 37.3 also establishes a procedure whereby a specific DTF may make an individualized showing under section 5a(b)(2)(E) of the Act that a contract is highly unlikely to be susceptible to the threat of manipulation and should be eligible for trading on that DTF in light of the characteristics of the commodity and the market's surveillance history, including its self-regulatory record, capacity and undertakings. Rule 37.3(a)(6) lists the factors that are relevant in making such a showing.

New part 37 provides greater administrative flexibility than the CFMA in the registration and oversight of DTFs, including provisions that (1) permit the Commission to register a DTF upon conditions; (2) provide a fast-track review procedure for applications for registration; and (3) permit applicants for DTF registration voluntarily to demonstrate their capacity to comply with the core principles for operation.<sup>30</sup> The Commission has provided two appendices giving general guidance regarding applying for registration and compliance with core principles.

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(B) the underlying commodity has a deliverable supply that is sufficiently large that the contract is highly unlikely to be susceptible to the threat of manipulation; [or]

(C) the underlying commodity has no cash market[.]

Section 1a(13) of the Act, as amended, defines an “excluded commodity” to mean, among other things, an interest rate, exchange rate, currency, credit risk or measure, debt instrument, measure of inflation, or other macroeconomic index or measure. Excluded commodities under section 1a(13) of the Act include exempt securities. Unlike the provisions governing exempt boards of trade, the CFMA imposes no specific limitations or requirements for exempt securities to trade on a DTF.

<sup>30</sup> Existing contract markets need not make such a demonstration. They simply must notify the Commission of their intent to operate as a DTF, and file with the Commission the DTF's rules (or a list of its rules) and a certification that they meet all of the requirements for registration as a DTF.

Rule 37.6(d) includes interpretations of certain core principles. For example, it provides that an electronic trading platform used by eligible commercial entities only, may satisfy the requirement to monitor trading in a manner “appropriate to the market” by assuring compliance with its rules regarding access limitation; that the core principle on monitoring trading may be met, appropriate to the market, by providing information to the Commission as requested; and that the core principle concerning fitness standards applies to natural persons who directly or indirectly have greater than a ten percent ownership interest in a non-member-owned facility. Rule 37.7 includes several special call provisions for requesting information from a DTF, or its market intermediaries or participants. Finally, the Commission has used its section 4(c) exemptive authority to give DTFs greater procedural flexibility in amending their rules.

The Commission, based upon administrative experience in processing applications for registration following proposal of the rules, is modifying the time period for voluntary approval of the applicant’s operating rules and for one product to be listed for trading on the facility. Upon registration as a DTF, the facility may list products for trading that meet the automatic eligibility and other requirements by notification to the Commission. Alternatively, it may submit new products for voluntary approval under the forty-five day fast-track review period of rule 40.3. Although no commenter specifically raised the issue, the Commission, after further consideration occasioned by inquiries from potential applicants, is modifying rule 37.7 by adding a new paragraph (c)(2) to provide that the facility’s operating rules, if Commission approval is requested, and one initial contract, if submitted for voluntary approval with an application for DTF registration, will be deemed approved in thirty days, rather than the normal forty-five day period under rule 40.3(b). This modification will enable an applicant for DTF registration to

have its operating rules and one product considered by the Commission for approval under the same time-frame as the registration application itself. Because this is an exception to the normal review period, it is being limited to one product only. Such a submission for voluntary product approval must comply in all other respects with the requirements of rule 40.3.<sup>31</sup>

In addition, commenters made a number of suggestions for modification of, or raised issues relating to, the rules as proposed. These comments relate to eligibility of persons for trading, eligibility of commodities for trading, and interpretations regarding several of the registration criteria and core principles. Several commenters also suggested a number of specific textual clarifications.

1. Trader eligibility.

The Commission proposed to include registered floor brokers and floor traders as eligible for trading on a commercial DTF. See proposed rule 37.1(b). CBT, NYMEX, and @Markets supported this proposal. NY Bar, however, opposed the proposed rule's requirement that an FCM guarantee the trades of such a qualifying floor broker or floor trader, arguing that "[i]t should be sufficient if the floor trader or floor broker is simply 'qualified,' i.e., that an FCM has agreed to accept all of the broker or trader's trades, instead of being fully guaranteed." CL 19-3; see also CL 5-3. The Commission does not agree that "acceptance" of all trades rather than a guarantee is sufficient. A guarantee provides formal assurance that another's obligation will be

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<sup>31</sup> Product approval is voluntary, and an applicant is not required to submit any of its products for Commission approval.

fulfilled, a level of assurance not necessarily provided by acceptance.<sup>32</sup> The Commission believes that this higher level of assurance is both necessary and appropriate for eligibility by floor brokers and floor traders as commercial entities, and is adopting the final rule as proposed.

The Commission also requested comment on whether the definition of “eligible commercial entity” under proposed rule 37.1(b) should be amended to include individuals whose function in electronic markets is similar to that provided by floor traders. A number of commenters generally supported including individuals who perform market-making functions on electronic trading facilities within the definition of eligible commercial entity. See CL 6-2, CL 4-2. @Markets, for example, opined that “B2B markets are in their infancy”; “certain markets may find that individual market makers are a critical element in accruing necessary liquidity”; and “in lieu of the registration requirement . . . such individuals [should] . . . meet the requirements for membership established by the facility.” CL 6-3.

NYBOT and NY Bar suggested that such a liquidity provider for electronic markets should be considered to be any eligible contract participant that “undertakes to maintain a bid and ask spread pursuant to an agreement with, or the rules of, an electronic trading facility.” CL 5-1; CL 19-2. CBT suggested that the electronic market equivalent of a floor trader would simply be a member that has its trading guaranteed by an FCM, and that is subject to the trade practice and disciplinary rules of exchanges. CL 7-4. However, that description would be a meaningful distinction only in the context of an intermediated market. Rather than attempting to

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<sup>32</sup> Several exchanges, including CBT, NYMEX and CME, require clearing guarantees for trades by non-clearing members.

establish a rule at this time, NYMEX suggested that the Commission make such determinations over time on a case-by-case basis for each facility seeking regulatory relief in this area. CL 10-5. SIA, although supporting the concept of a functional equivalent of a floor trader for electronic markets, noted that “most corporate entities in that category would already fall within the statutory definition of eligible commercial entity.” CL 20-3. In light of the wide range of recommended standards, the suggestion by at least one commenter that existing categories already would cover those likely to fall within the scope of a new category for electronic market maker, and the lack of previous trading experience, the Commission is of the view that the issue should be considered based upon a fuller administrative record, after some trading experience with this type of market has been observed.

NY Bar suggested that the Commission clarify that “[s]ection 37.3(b) is intended to permit a non-eligible commercial entity to access a commercial entity [DTF] through any FCM or broker-dealer.” CL 19-3. Access to trade on a DTF generally is limited to eligible traders under rule 37.3(a). Eligible traders are either eligible contract participants or non-eligible contract participants trading through a registered FCM that (1) is a member of a futures self-regulatory association (or for a facility trading only security futures products, a national securities association); (2) is a clearing member of a derivatives clearing organization; and (3) has at least \$20 million net capital. See section 5a(b)(3) of the Act. Moreover, for transactions other than security futures products, a DTF may by rule permit a broker-dealer or a depository or Farm Credit System institution to act as intermediary “on behalf of customers” if such entities do not hold customer funds for more than one business day. See section 5a(e) of the Act.

In contrast to these provisions, section 5a(a)(2)(F) of the Act provides that a commercial DTF may trade any commodity (other than an enumerated agricultural commodity)<sup>33</sup> when access to trade on the facility is limited to eligible commercial entities trading for their own account. Based upon this statutory language, commercial DTFs under rule 37.3(b) are limited to eligible commercial entities (as defined in §37.1(b)) trading for their own account. Accordingly, commercials may not execute their trades through an FCM, or any other intermediary, when trading on a commercial DTF under rule 37.3(b).<sup>34</sup>

## 2. Commodity eligibility.

Consistent with section 5(e)(2) of the Act, the Commission indicated in its notice of proposed rulemaking that it will determine in a future rulemaking whether to permit and, if so, the appropriate conditions for permitting, the enumerated agricultural commodities to trade on a DTF. 66 FR 14264. A number of commenters responded by suggesting that the enumerated agricultural commodities should be permitted to trade on a DTF immediately. See CL 3-3, CL 9-1, CL 18-4. The Commission intends to turn its attention to this issue at a later date in a separate rulemaking.

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<sup>33</sup> The enumerated agricultural commodities are those listed in section 1a(4) of the Act, and include, among others: wheat, cotton, rice, corn, soybeans and the soybean complex, livestock, and frozen concentrated orange juice.

<sup>34</sup> Consistent with this provision, rule 37.1(b) includes floor brokers within the definition of “eligible commercial entity” only when trading for their own account.

As a class of excluded commodities, exempt securities are eligible to be traded on a DTF. The Commission requested comment on whether exempt securities trading on a DTF should be subject to additional requirements, such as reporting requirements, not applicable to other excluded commodities.<sup>35</sup> CBT explained that it “has found large trader reporting to be a useful tool for monitoring trading of futures and options on exempt securities,” but wanted “the form, levels and timing of any such reporting” left to the discretion of individual DTFs. CL 7-5.

ISDA did not object “in principle” to the imposition of such requirements, but cautioned against imposing regulatory requirements in the absence of a “compelling public interest.” CL 3-3. SIA suggested that any large-trader reporting requirement should be consistent with market practice in the relevant cash market and only upon request of the Commission. CL 20-2.

On the other hand, the United States Department of the Treasury (Treasury) expressed the opinion that all DTFs and contract markets should enforce a large-trader reporting system for contracts based on Treasury instruments. Treasury “reiterate(d) its belief that large trader reporting requirements . . . reveal information that is useful to regulators, and also have a deterrent effect.” CL 14-2.

In light of all of the comments received, the Commission at this time has determined not to impose routine large-trader requirements on DTFs or their users for contracts based on Treasury instruments. Should market conditions warrant, however, the Commission will invoke

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<sup>35</sup> The proposed rules provided that commodities defined in section 1a(13) of the Act as “excluded commodities” meet the deliverable supply eligibility test for trading on a DTF. Such excluded commodities include interest rates, currencies, securities, security indexes,

its special call authority under Rule 37.8 to require such information for these contracts as the Commission deems necessary, taking into consideration the surveillance information routinely available with the DTF. The Commission's special call could require, for example, ongoing reporting of large-trader positions or other appropriate information.

In addition to excluded commodities and security futures products, the Commission, under rule 37.3(a)(6), may make an individualized determination by rule, regulation or order, that a commodity is eligible to be traded on a DTF based on the commodity's characteristics and surveillance history, and the self-regulatory record and capacity of the facility on which it is to be traded. NYMEX questioned whether such determinations were included under the thirty-day period that applies to applications for DTF registration. If not, NYMEX requested that "the Commission specify a comparable timeframe for such determinations that would provide for resolution of such applications in a reasonably expeditious manner." CL 10-2.

The timing of an individualized Commission determination of commodity eligibility under rule 37.3(a)(6) is independent of a facility's initial registration as a DTF. In this regard, the rules do not require that a product be submitted for approval at the time the facility is registered as a DTF. Accordingly, the thirty-day time period for registration is independent of, and does not control, any product-specific consideration. Moreover, the Commission proposes to make case-by-case determinations with regard to eligibility of a commodity to trade on a DTF after notice and an opportunity for hearing through submission of written data, views and

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macroeconomic and other types of indexes, and occurrences associated with an economic consequence beyond the control of the traders.

arguments. A number of commenters, including NYMEX and NYBOT, suggested that a petitioning DTF or applicant for DTF registration should be accorded the right to request an opportunity to present oral views and testimony to the Commission. CL 5-3, CL 10-3. The Commission concurs and will consider granting such requests in appropriate instances. Such an opportunity to present views, facts and argument orally before the Commission is not consistent with a thirty-day deadline. Accordingly, recognizing the potentially complex and highly individualistic nature of each determination, the Commission is not modifying the final rule by including a deadline. Nonetheless, the Commission intends to make these determinations expeditiously.

NYMEX also requested that the Commission clarify that the relevant approval criteria are “meaningful only in relative terms, *i.e.*, in comparison to other markets”; that “it is not necessary for a contract to meet all of these factors”; and how these factors might be interpreted for cash-settled or index-based contracts. CL 10-3. The Commission believes that a demonstration that a commodity meets the criteria of rule 37.3(a)(6)(ii) can be made either on an absolute basis or relative to a market that clearly meets the requirement that a “commodity is highly unlikely to be susceptible to the threat of manipulation.”<sup>36</sup> The Commission will consider such a demonstration based upon the totality of the showing, but will separately consider the petitioner’s surveillance history and self-regulatory record from the commodity’s general cash market characteristics. Nevertheless, the Commission would consider undertakings for enhanced surveillance and self-regulatory measures (beyond the required large-trader reporting system), such as spot-month

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<sup>36</sup> In this regard, the excluded commodities defined in section 1a(13) of the Act clearly meet this standard, and may be used as a benchmark for comparison.

speculative position limits, as an appropriate means to address instances where cash market characteristics alone may not provide sufficient assurance that the commodity is highly unlikely to be susceptible to the threat of manipulation.

With regard to cash-settled contracts, the Commission is modifying sub-paragraph 37.3(a)(6)(ii)(G) to make clear that the facility should be able to show that the contract or product's terms and conditions provide for a reliable and acceptable cash-settlement procedure that is adequate to minimize the threat of market abuse. The other criteria enumerated in paragraph (a)(6) apply equally to cash and physically settled contracts.

### 3. Registration procedures.

Proposed rule 37.5(a)(2) would have required that a contract market filing notice that it wishes to operate as a DTF include in its submission a copy of the facility's rules. NYBOT opined that "this should not be necessary, since the rules of the contract market would already be on file with the Commission, unless and to the extent the DTEF rules are different." CL 5-3; see also CL 15-4 (MGE). The Commission is modifying the final rule to provide that the notification need only list those rules of the contract market that also apply to operation of the DTF.<sup>37</sup>

### 4. Interpretations of registration criteria and core principles guidance.

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<sup>37</sup> The Commission is not modifying the provisions relating to DTF applications for registration. The notification procedure is an abbreviated procedure for existing contract markets. Applicants for registration generally will not have pre-existing approved or certified rulebooks.

The Commission proposed in its registration guidance in Appendix A that “[i]f cleared, transactions executed on the facility must be cleared through a derivatives clearing organization.” However, in a subsequent notice of proposed rulemaking to implement the CFMA with respect to derivatives clearing organizations (DCO), the Commission clarified that,

excluded or exempted contracts, including those elected pursuant to section 5a(g) to be traded on a registered derivatives transaction execution facility, are not required to be cleared by a DCO, although a clearing organization that clears these contracts may voluntarily apply, pursuant to section 5b(b), to register with the Commission as a DCO.

66 FR 24308 (May 14, 2001).

SIA, in commenting upon the guidance in Appendix A, asserted that the registration guidance should be modified to recognize that contracts that are traded on a DTF on an “opt-in” basis are not required to be cleared by a DCO. CL 20 at 2. NY Bar asserted that a DTF should be permitted to clear through any recognized clearing organization including, e.g., clearing organizations supervised by domestic and foreign banking authorities. CL 19- 4-5. In light of these comments, and the fact that no comments were submitted in response to the Commission’s clarification in the Federal Register notice proposing rules for clearing organizations, the Commission is modifying the guidance in Appendix A to make clear that agreements, contracts and transactions in excluded or exempt commodities that are traded on a DTF, if cleared, may be cleared through clearing organizations other than DCOs registered with the Commission.

With regard to Appendix B for DTFs, Guidance on Compliance with Core Principles, NYBOT and NY Bar suggested that the Commission add a statement similar to one included in the guidance for contract markets (Appendix B of part 38), that “[b]oards of trade that follow the specific practices outlined . . . for any core principle below will meet the applicable core principle.” CL 5-4, CL 19-4. The guidance for DTFs, however, in keeping with the less

regulated nature of those markets, is abbreviated and general in nature, and does not include the same level of detail as the guidance for contract markets. Accordingly, unlike the guidance for contract markets, the guidance for DTFs does not outline specific acceptable practices.

NYBOT objected that the guidance on “minimum” fitness standards under Core Principle 6 for persons who have member voting privileges, governing obligations or responsibilities, or who exercise disciplinary authority, is not provided for in the CFMA and is unnecessarily onerous.<sup>38</sup> CL 5-4. The Commission agrees in part and has modified the guidance accordingly.<sup>39</sup> The guidance in Appendix B relating to minimum fitness standards interprets Section 5a(d)(6) of the Act, which requires DTFs to “establish and enforce appropriate fitness standards.” In the Commission’s view, the fitness standards for the named categories of persons that should apply at a minimum include the statutory disqualifications in section 8a(2) of the Act. Of course, DTFs remain free to impose higher fitness standards, including the statutory disqualification standards of section 8a(3) of the Act.<sup>40</sup> Persons who have governing obligations or responsibilities, or who exercise disciplinary authority, should not have a significant history of serious disciplinary offenses, such as those that would be disqualifying under rule 1.63.

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<sup>38</sup> NYBOT also asserted that there should not be any fitness standards for natural persons who directly or indirectly have greater than a ten percent interest in the facility and are merely passive investors. This issue is addressed above in connection with comments related to a similar provision applicable to contract markets.

<sup>39</sup> The Commission has made similar modifications to the guidance governing designated contract markets contained in Part 38, Appendix B, Core Principle 14.

<sup>40</sup> The Commission notes that these minimum standards are consistent with the fitness standards that Congress itself adopted for exempt commercial markets. In this regard, section 2(h)(5)(A)(iii) of the Act requires an exempt commercial market to certify to the Commission that “no executive officer or member of the governing board of, or any holder of a 10 percent or greater equity interest in, the facility is a person described in any of subparagraphs (A) through (H) of section 8a(2)[.]”

CME and NYMEX commented that disclosing information on system security, as the proposed guidance on Core Principle 4 suggests, might compromise a system's integrity. CL 10-4, CL 18-4. The guidance did not intend that detailed, proprietary information on system security should be disclosed, and in light of these comments, the Commission has deleted this provision.<sup>41</sup>

### **C. Product Listing and Rule Amendments**

Proposed part 40 would implement the procedural provisions of Section 5c(c) of the Act for new contracts, new rules and rule amendments.<sup>42</sup> Based on administrative experience after the part 40 rules were proposed, the Commission is amending rule 40.4 to provide contract markets greater certainty with respect to the approval of rules governing contracts on enumerated agricultural commodities. First, the Commission is adding to the list of non-material rule changes the category of rule changes necessary to comply with a binding court order, or with a rule or order of the Commission, or of another federal regulatory authority. Second, the Commission is adding a provision to the final rules that permits a contract market to submit to the Commission any rule that the contract market believes not to be material, but that is not listed as non-material in rule 40.4, and to implement the rule ten days after submission, absent contrary notice from the Commission. This procedure gives exchanges flexibility by providing that the

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<sup>41</sup> The Commission has made a similar modification to Part 38, Appendix B, Core Principle 9. See comment of MGE, CL 15-3.

<sup>42</sup> In proposing these rules, the Commission noted that, in light of the Congressional intent to implement the provisions of the CFMA without delay, during the transition period between the effective date of the CFMA and promulgation of final implementing rules, the Commission would not take any enforcement action against any person who complied with the implementing rules, as proposed. 66 FR 14268.

listed categories are non-exclusive and at the same time provides a method to obtain certainty that the Commission agrees that the rule change is not material.<sup>43</sup>

While commenters strongly endorsed the increased flexibility of the proposed rules, see CL 7-2, CL 10-2, CL 18-1, several objected to certain specific requirements. In response to these comments, the Commission has decided to modify the proposed rules as discussed below.

1. Clearing.

BOTCC objected to the provision of proposed rule 40.2, which would have required a DCO to certify, with respect to a product that it clears that is not traded on a contract market or a DTF, that the trading product or instrument complies with the Act. BOTCC questioned the Commission's authority to require this certification, and questioned how a DCO could make such a certification "about a product or instrument that it has not designed and for which it is providing only a discrete set of services." CL 1-5. As an alternative, BOTCC suggested that the

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<sup>43</sup> CBT correctly asserted that rules listing additional delivery months for agricultural contracts should not be deemed to be material under rule 40.4, and thus subject to the requirement of prior approval. CL 7 at 2. Pursuant to section 5c(c)(B)(2) of the Act, the listing of additional delivery months is not subject to the prior approval requirement because such rules do not apply "to contracts and delivery months which already have been listed for trading and have open interest." 7 U.S.C. 7c(c)(2)(B).

CME asserted that the Commission should not retain the distinctions between in-house changes and those made by third parties with respect to delivery standards and index constructions and calculations. It asserted that "there are sufficient safeguards embodied in the core principles to make requirements at this level of detail obsolete." CL 18 at 5. The Commission notes that it exercised its section 4(c) authority to excuse independent third party delivery and index changes from the statutory certification requirement for all rule changes in recognition that such rule changes are subject to the additional safeguard of being determined by the action of an independent party, for purposes not solely related to trading in derivatives contracts or to trading on the exchanges.

Commission could require the DCO to certify that its clearing of the product complies with the Act, although it questioned the practical utility of such a certification.

Under section 5c(c) of the Act, a registered entity may elect to “accept for clearing any new contract or other instrument, or may elect to approve and implement any new rule or rule amendment” by certifying to the Commission that “clearing of the new contract or instrument, new rule or rule amendment complies with [the] Act.” The Commission is clarifying rule 40.2 to provide that a DCO may accept for clearing any new contract or other instrument by filing with the Commission: (i) the rules of the DCO that permit it to accept the contract or other instrument for clearing (including any rules establishing the terms and conditions of products that make them acceptable for clearing); and (ii) a certification that the clearing of the new contract or instrument (including any rules establishing the terms and conditions of products that make them acceptable for clearing) complies with the Act. By so certifying, the DCO will be certifying not only that it is in compliance with the core principles applicable to it, but that its rules permitting acceptance for clearing (including any rules establishing terms of the product to be accepted for clearing) comply with the Act. These filing and certification requirements, as proposed, do not apply when a DCO accepts a new product for clearing that is traded on a contract market or a registered DTF.<sup>44</sup>

## 2. Product listing.

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<sup>44</sup> BOTCC objected to including clearing organizations within the definition of “contract market” under proposed rule 40.1. BOTCC reasoned that this definition was unnecessary and confusing since the Act now separately regulates trading facilities and clearing organizations. CL 1-4. The Commission agrees and has deleted the proposed definition from the final rules.

CME objected to the requirement that trading facilities certify to the Commission compliance with the Act when relisting dormant contracts for trading. See proposed rule 40.2. CME argued that the proposed certification requirement for dormant contracts is a “relic of the days of more intensive regulatory administration.” CL 18 at 5. The Commission disagrees. Contracts become dormant only after five years from initial listing<sup>45</sup> and cash markets are likely to change during that period. Consequently, the product as originally certified may no longer be in compliance with the applicable core principles. The recertification requirement is in keeping with the Commission’s oversight role.

### 3. Rule submissions.

Proposed rule 40.5 would have established procedures for the voluntary submission of rules for Commission review and approval.<sup>46</sup> CBT objected that this rule would result in a potentially longer review process than was provided for under the Commission’s fast track review procedure prior to enactment of the CFMA. CL 7-2.

Proposed rule 40.5 provided for a 45-day review period of rules submitted for Commission approval, with the possibility that the Commission could extend the review period once, for another 45 days, which would have comported with the statutory review period of 90 days. On further reflection, the Commission has determined to retain the review periods of its

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<sup>45</sup> See proposed Commission rule 40.1, which defines “dormant contract” as any futures or option contract in which no trading has occurred for six months beginning five years after initial listing.

<sup>46</sup> Those procedures are also incorporated by reference in proposed rule 40.4, which implements the statutorily-mandated review and approval procedures for certain amendments to contracts involving enumerated agricultural commodities.

pre-CFMA fast track procedure: one 45-day initial review period, with the possibility of one 30-day extension.<sup>47</sup>

When the Commission does not approve the rule of a registered entity submitted to it for voluntary approval, proposed rule 40.5(d) provided that the non-approval notice must briefly specify the nature of the issues raised and the specific provision of the Act or regulations, including the form or content requirement of rule 40.5, that the facility's rule would violate, appear to violate, or the violation of which could not be ascertained from the submission. Notice of the Commission's refusal to approve a registered entity's rule would have been presumptive evidence that the registered entity could not truthfully certify that the same, or substantially the same, proposed rule or rule amendment did not violate the Act or rules thereunder. See proposed rule 40.5(e).

BOTCC argues that the presumption established by rule 40.5(e) is ill-advised, procedurally flawed, discourages rule submissions and should be withdrawn. CL 1-5. The Commission is not persuaded. The presumption established by rule 40.5(e) is not a conclusive, but rather, is a rebuttable presumption. If the registered entity were to certify such a rule following notice of non-approval, the burden of proceeding would rest with the Commission.<sup>48</sup>

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<sup>47</sup> As suggested by NYBOT and NY Bar, the Commission is modifying rule 40.6(a) by adding a parenthetical to make explicit that the self-certification requirement of rule 40.6 applies to all new rules or rule amendments of a contract market or DTF other than those rules or rule amendments that have been approved by the Commission under the voluntary approval procedures of rule 40.5. See CL 5-6 and 19-7. This does not preclude a contract market or DTF from voluntarily submitting a rule for Commission approval under rule 40.5 that it has already implemented by certification under rule 40.6.

<sup>48</sup> In such a proceeding, the Commission would be required to satisfy the applicable legal standard. In a proceeding to alter or supplement the rules of a registered entity, the Commission would be required to establish that such changes "are necessary or appropriate for the protection

In any administrative proceeding brought by the Commission, the registered entity would have an opportunity to supplement the record with evidence rebutting the presumption. Moreover, as the proposed rule makes clear, nothing will prejudice a registered entity's right to resubmit a revised rule or to supplement the submission. Accordingly, the Commission does not believe that this presumption will discourage voluntary rule submissions.

Proposed rule 40.6 provides that the Commission may stay the effectiveness of a certified rule during the pendency of Commission proceedings for filing a false certification or to alter or amend the rule pursuant to section 8a(7) of the Act. CBT objected to the stay provision on the grounds that section 8a(7) does not reference a stay and that it is unnecessary and potentially detrimental for the Commission to have such authority. CL 7-3; see also CL 18 at 2-3. BOTCC, while expressing sympathy for the Commission's concern that an improperly adopted rule not be permitted to remain in effect pending the conclusion of the administrative proceeding, suggested that the Commission modify the rule to specify that any stay will not affect contracts and positions previously established in reliance on the disputed rule and that the Commission endeavor to delay the effectiveness of any such stay in order to give the registered entity and market users an opportunity to make appropriate arrangements. CL 1- 6, note 4.

The Commission recognizes the potential market implications of a stay of a previously implemented rule or rule amendment. The Commission has not delegated this authority to its

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of persons producing, handling, processing, or consuming any commodity traded for future delivery on such registered entity . . . or for the protection of traders or to insure fair dealing in commodities traded for future delivery on such registered entity." 7 U.S.C. 12a(7). In an administrative enforcement proceeding alleging a false certification, the Commission's findings of fact must be supported by "the weight of the evidence." 7 U.S.C. 8(b).

staff. The Commission intends to invoke its stay authority cautiously, and only in the rare instance when its use would be appropriate.

FIA requested confirmation that the Commission will solicit comment on rules submitted for voluntary approval when warranted. CL 11-6-7. The Commission confirms its intent to solicit public comment in such cases and further confirms its intent to solicit public comment in appropriate cases on interpretations issued or approved under section 5c(a) of the Act.<sup>49</sup>

#### 4. Emergency rule submissions.

CME commented that the proposed definition of emergency in proposed rule 40.1 is too broad and particularly objected to including within the definition “any action taken by any governmental body, or any other board of trade, market or facility which may have a direct impact on trading on the trading facility.” CME argued that this definition could require the “declaration of an emergency if . . . the Federal Reserve changes the fed funds rate.” CL 18-5. The proposed language is substantially identical to language included in the Commission’s current definition,<sup>50</sup> and is consistent with the Act’s definition of emergency.<sup>51</sup>

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<sup>49</sup> BOTCC commented that the procedures governing amendments to the terms and conditions of contracts involving enumerated agricultural commodities, consistent with the Act, should apply only when the contract is traded on a designated contract market, and not when traded on a registered DTF pursuant to section 5a(g) of the Act. CL 1- 5. The Commission agrees and has amended rule 40.4 accordingly.

<sup>50</sup> See 17 C.F.R. 1.41(a)(4)(iv)(2001).

<sup>51</sup> Section 8a(9) of the Act vests the Commission with emergency authority. The term emergency is defined to include “in addition to threatened or actual market manipulations and corners, any act of the United States or a foreign government affecting a commodity or any other major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for such commodity.”

BOTCC, CME and NYMEX objected to the provisions of rule 40.6 that would require a contract market or registered DCO to file emergency rules at the time of implementation, if implementation is sooner than the next business day. CL 1-7-8; CL 10-4; CL 18-5. CME commented that this notification requirement “more closely resembles micromanagement than oversight. It has the effect of requiring a DTEF to concern itself with an administrative procedure rather than concentrating on the emergency itself.” CL 8-5

After considering these comments, the Commission has decided to modify rule 40.6 to require the contract market or DCO to file rules implemented pursuant to an emergency at the earliest possible time after implementation of the rule (but in no event later than 24 hours after implementation), if it is not practicable for the contract market or DCO to file the rule prior to implementation.<sup>52</sup>

#### **D. Part 36—Exempt Markets**

Part 36 applies to any board of trade or electronic trading facility eligible for exemption under sections 5d and 2(h)(3) through (5) of the Act, respectively.

Section 5d of the Act establishes the category of “exempt board of trade.” Commission rule 36.2 defines those commodities that are eligible to trade on an exempt board of trade to include commodities defined in section 1a(13) of the Act as “excluded commodities,” other than securities, and such other commodities as the Commission may define by rule, regulation or

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<sup>52</sup> This is consistent with the approach taken in the current rules regarding the timing of notification of rules implemented pursuant to an emergency. See 17 C.F.R. 1.41(f)(2)(i).

order. In addition, rule 36.2(b) provides the form and manner of the notification to the Commission provided for under section 5d of the Act.

Transactions by eligible commercial entities in exempt commodities traded on an electronic trading facility are exempt commercial markets under section 2(h)(3) of the Act.<sup>53</sup> Markets that satisfy the initial and ongoing requirements of sections 2(h)(3) through (5) of the Act as amended are excluded from the Act's other requirements. The rules implement the notification requirements of section 2(h)(5)(A) of the Act and the information requirements for exempt commercial markets consistent with section 2(h)(5)(B) of the Act.<sup>54</sup> Generally, the part 36 rules incorporate by reference the statutory conditions that pertain to these exemptions, including the statutory provisions relating to eligibility.

#### 1. Exempt Boards of Trade.

Several commenters suggested that the Commission expand the commodities eligible to be traded on exempt boards of trade (EBOT) trading under proposed rule 36.2. ISDA stated that it "believes it is important that the Commission indicate its intention to act with dispatch in designating additional commodities that may be traded on an exempt board of trade." CL 3-4. SIA suggested that the Commission "does not need to foreclose the determination that other commodities could satisfy the statutory standard for eligibility or to require in all cases that such

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<sup>53</sup> See note 9 *supra*.

<sup>54</sup> As proposed by rule 36.3(b), if an exempt commercial market chooses not to satisfy its reporting requirements by providing the Commission with electronic access to transactions conducted on the facility, it may do so by an alternative means, the form and content of which the Commission may determine is acceptable, pursuant to a petition to the Commission for such a determination. Such an alternative should provide the Commission with information

a determination be made by the CFTC, where such a determination is not required by statute." CL 20-3. The Commission believes that the commodities defined as excluded under section 1a(13) of the Act clearly meet the statutory criteria to be traded on an EBOT. The Commission has not foreclosed the possibility of finding additional commodities eligible for trading on an EBOT at some future time by rule, regulation or order.

## 2. Exempt Commercial Markets.

With respect to the eligibility of traders to participate in exempt commercial markets, Energy Group "suggest[ed] that the Commission consider clarifying the definition of principal for the purposes of principal-to-principal transactions to include eligible commercial entities entering into transactions on behalf of other eligible commercial entities." CL 4-2. As noted above, the Commission's proposed rules relating to exempt commercial markets rely directly upon the statutory definitions and conditions relating to the section 2(h)(3) exemption. Any interpretation by the Commission of the definition of "principal" relating to eligible commercial entities necessarily would include consideration of the use and meaning of that term as it relates to other statutory exclusions or exemptions, and is beyond the scope of this rulemaking.

With respect to the reporting requirements set forth in part 36, see note 55 supra and accompanying text, @Markets expressed the view that "regular and periodic" reports were beyond the scope of the Commission's authority under section 2(h)(5)(B) of the Act and Energy Group suggested that "the focus on meeting 'large trader' requirements is unnecessary for the Commission to fulfill its responsibilities under the CFMA." CL 4-2. The Commission

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comparable in coverage and frequency to that provided to the Commission by its large-trader reporting system.

disagrees. Section 2(h)(5)(B) of the Act requires that an exempt commercial market provide the Commission with electronic access to the market. The access requirement provides the Commission with information on a routine, on-going basis, thereby serving many of the functions that large-trader reports serve on the regulated markets. Using this access, the Commission is able to surveil transactions on the market in order to enforce its anti-manipulation authority. The alternative to providing electronic access set forth in rule 36.3(b) is intended to offer exempt markets a substitute, but generally equivalent, means of complying with the statutory electronic access requirement.

Two commenters raised issues relating to proposed rule 36.3(c)(3), under which a facility must require that each participant agree to comply with all applicable law and must have a reasonable basis for believing that its participants are eligible. BOTCC suggested that the Commission clarify that the provision requiring each participant “to agree to comply with all applicable law is intended to be limited to applicable provisions of the Act and Commission regulations.” CL 1-4; see also CL 4-2 (Energy Group). That is indeed the intended meaning of the rule.

Finally, @Markets requested that the Commission “confirm that an exempt commercial market will be deemed to be a ‘board of trade’ for purposes of the confidentiality provisions of section 8(a) of the Act and the relevant provisions of the Freedom of Information Act.” CL 6-4. Unlike contract markets and DTFs, which are specifically referred to as “boards of trade” in the Act, exempt commercial markets are not specifically referred to by the Act as “boards of trade.” Compare sections 5(a) and 5a(a) of the Act with section 2(h)(5) of the Act. Nevertheless, section 8(a) of the Act generally prohibits the Commission from publishing “data and information that

would separately disclose the business transactions or market positions of any person.” “Person” under section 1(a)(16) of the Act includes individuals, associations, partnerships, corporations and trusts, and would thereby apply to an exempt commercial market and to those trading thereon.

### 3. Common provisions.

Part 36 provides that both exempt boards of trade and exempt commercial markets be required to disseminate publicly their trading volume, opening and closing price ranges, open interest and other trading data, to the extent appropriate to that market upon a Commission finding that the facility serves as a significant source for the discovery of prices in the cash market for the underlying commodity. Rules 36.2(c)(2) and 36.3(c)(2) provide that the Commission will make such a determination after notice and an opportunity for hearing through submission of written data, views and arguments.

A number of commenters suggested modifications to the rule. BOTCC noted that price information is an important source of revenue for exchanges and suggested that the Commission revisit the public dissemination requirement at a future time after "a fuller opportunity to evaluate the appropriate balance of public interests entailed by such requirement." CL 1-3. @Markets noted that although "neither the Act nor the proposed rules define the standards that the Commission is to employ in determining that a market performs a significant price discovery function, [it] would expect to have the opportunity to comment on appropriate standards prior to or in connection with any such determination by the Commission under this section of the Act.”

CL 6-2. Others commented that oral hearings should not be precluded in appropriate cases. CL 5-2, CL 19-4.

The Commission agrees with the above comments. Although the Commission has provided that its determination will be made through notice and an opportunity for hearing through submission of written data, views and comments, it is not precluded from convening a public meeting to receive oral comment and argument in appropriate cases. The Commission may determine sua sponte, or in response to a request by the affected trading facility, or any interested member of the public, that a public meeting to receive oral statements and arguments is in the public interest and will assist it in its consideration of the relevant issues. As part of its inquiry, the Commission would set forth the standards that it would use in making its determination. The facility, and other interested members of the public, would have an opportunity to challenge those standards and to raise any other objections or defenses to the issuance of an Order, including any possible adverse impact on a facility's property rights that may stem from the proposed order. The Commission is of the view that these issues are best addressed in the context of a fully-developed administrative record, rather than in the context of this generalized rulemaking. Accordingly, the Commission is adopting the final rules on procedures relating to price discovery determinations as proposed.

The Commission invited comment on whether exempt boards of trade and exempt commercial markets should be required affirmatively to disclose to traders that the facility and trading on the facility are not regulated or approved by the Commission. 66 FR at 14266. Commenters responding to this question generally opposed requiring facilities to affirmatively

make such disclosures. But see CL 10-5 (NYMEX); CL 12-2 (SUA). For example, Energy Group suggested that

[a]n exempt commercial market is open only to sophisticated market participants who are familiar with distinctions among the different facilities. Such participants would have no reason to believe such a facility is regulated . . . . A representation affirming that the facility is not regulated may cause confusion.

CL4-2. SIA and @Markets concurred with this view, noting respectively that “[i]n light of the institutional character of these markets . . . such disclosure is not necessary,” and that “the participants in these markets . . . can be expected to make appropriate inquiries regarding a market before applying for trading privileges on the facility.” CL 20-3; CL 6-4.

The Commission agrees that eligible contract participants and eligible commercial entities can be expected to make appropriate inquiries regarding whether a market is regulated and is not requiring exempt boards of trade or exempt commercial markets affirmatively to disclose that they are not regulated or approved by the Commission.

## **E. Miscellaneous**

### **1. Anti-fraud.**

The Commission additionally proposed an anti-fraud provision, proposed rule 1.1, pursuant to its authority in sections 3 and 8a(5) of the Act. This proposed anti-fraud rule would apply to retail foreign currency agreements, contracts and transactions described in section 2(c)(1) of the Act.

A number of the commenters particularly supported this proposed rule. SUA noted that it was the clear intent of Congress that the Commission “retain broad powers to protect against fraud and manipulation” (CL 12 at 1). NYMEX “strongly support[ed] the proposed new rule.” (CL 10 at 4). CBT commented that the rule “addresses a regulatory gap with regard to . . . unregulated entities.” (CL 7 at 9). See also CL 11 at 6. NASAA, “welcome[d] the clarification of the Commission’s antifraud jurisdiction.” CL 2 at 1.

ISDA, however, suggested that the Commission expand the exclusion from the rule to include financial institutions, insurance companies, financial holding companies and investment bank holding companies.<sup>55</sup> Such entities need not be excluded from operation of the rule because they are outside of its intended scope in the first instance.<sup>56</sup> Accordingly, the Commission is adopting the rule as proposed.<sup>57</sup>

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<sup>55</sup> The rule excludes broker-dealers, FCMs and their respective affiliates.

<sup>56</sup> Rule 1.1 on its face applies only to “the extent that the Commission exercises jurisdiction over such accounts, agreements, or transactions as provided in section 2(c)(2)(B).”

<sup>57</sup> Separate from proposed rule 1.1, a number of commenters offered a range of opinion in response to the request for comment by Commissioner Thomas J. Erickson on the advisability of promulgating a broader anti-fraud rule. 66 FR at 14288. SUA supported a broader anti-fraud rule without qualification. CL 12 at 1. SIA did not object “in concept” to clarification by the Commission of its anti-fraud authority with respect to principal-to-principal transactions. CL 20 at 4. ISDA, however, warned that the Commission should proceed with caution in this area to avoid creating any uncertainty with respect to the scope of its jurisdiction. CL 3 at 5. Finally, FIA expressed doubt whether an anti-fraud rule of more general applicability would appreciably enhance the Commission’s authority to deter misconduct by persons subject to its jurisdiction, or the public’s ability to recover damages as a result of such misconduct. CL 11 at 6.

## 2. Delegation of functions.

NFA asked the Commission to clarify a contract market's and DTF's ability to delegate functions under the core principles, noting that:

the CFMA specifically allows contract markets and [DTFs] to comply with any of the core principles through delegation of functions to a registered futures association or another registered entity. . . . The Commission's current proposal, however, does not specifically authorize a [DTF] to delegate these functions (although NFA believes that the language is sufficiently broad to be interpreted to permit this delegation.)

CL 16-1.

Section 5c(b) of the Act specifically provides that both contract markets and DTFs may comply with any applicable core principle through delegation of any relevant function to a registered futures association or another registered entity. As NFA correctly notes, the rules as proposed are “sufficiently broad to be interpreted to permit this delegation.” Id.

NFA further suggests that the Commission, by rule, limit entities acceptable for “outsourcing” of functions to registered futures associations and registered entities because the statute so provides and because “Congress recognized that the Commission must have some authority over any entity carrying out these functions.” Id. Section 5c(b) of the Act, however, limits only “delegations” of functions to registered futures associations and to registered entities; it does not restrict “outsourcing” of specified activities on a contract basis.

The Commission has long-recognized the ability of contract markets to meet their self-regulatory obligations by using persons under contract to perform specified duties. The Commission has conditioned the use of outside contractors to perform duties in connection with self-regulatory functions upon the contract market “maintaining a sufficient degree of control

over the persons under contract,” and the person under contract having “no conflict of interest.” The Commission has further provided that, when using contractors to fulfill a self-regulatory function, it is the exchange’s responsibility to ensure that its obligations under the Act are met. Comm. Fut. L. Rep. (CCH) ¶ 6430, CFTC, (May 13, 1975.) Accordingly, contract markets have contracted for the performance of various services related to their operations and self-regulatory responsibilities, including compliance with various core principles. For example, contract markets or DTFs reasonably may be expected to outsource to various contractors functions relating to operating their trading platforms or to disseminating information required to be made public.<sup>58</sup>

In contrast to such contracting arrangements, a delegation confers upon another the authority to act in the delegating entity’s name. The distinction between delegation of authority and contracting for services is particularly well-illustrated in matters related to member discipline and market surveillance. A market that delegates these functions empowers the delegatee to take appropriate remedial actions, including the sanctioning of members or market participants for rule violations. In contrast, a market may contract with an entity to conduct trading surveillance and to investigate the facts surrounding alleged rule infractions. Unlike a delegatee, a contractor would not have the authority to decide on behalf of the delegating entity

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<sup>58</sup> Specifically, for example, the Merchants Exchange of St. Louis contracted with a technology company to operate its matching engine. A criterion for designation is that the contract market “establish and enforce rules defining . . . the operation of any electronic matching platform; and demonstrate that the trade execution facility operates in accordance with the rules.” See section 5(b)(4) of the Act. Under Core Principle (2), the contract market must monitor and enforce compliance with those rules. Consistent with long-standing Commission interpretation, it is reasonable for a contract market or a DTF to outsource these functions, in whole or in part, to a technology contractor.

whether an infraction had occurred or to impose remedial sanctions. These decisional functions can be exercised only by delegation of that authority to registered entities or a registered futures association, as Congress has provided.

Further, although section 5c(b)(2) of the Act provides that the Commission would have oversight authority over a delegatee because it is a registered entity, the contract market or DTF that delegates responsibilities under the Act also “shall remain responsible for carrying out the function.” Therefore, regardless of whether a registered entity has delegated functions or contracted for services, the entity must assure itself that the delegated functions or contracted services will enable it to remain in compliance with the Act’s requirements. Moreover, the registered entity must have a sufficient degree of control over the persons under contract because it remains the registered entity’s “responsibility to ensure that its obligations under the Act are met.” Id.

### 3. Arbitration.

Rule 166.5 governs the use of pre-dispute arbitration agreements. Under subsection (g) of the proposed rule, an eligible contract participant would have retained the right to bring a private right of action under section 22 of the Act, but could have been required, in accordance with an amendment to section 14(g) of the Act,<sup>59</sup> to waive the right to seek reparations.

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<sup>59</sup> See CFMA, section 118.

Several commenters questioned the need to retain the voluntariness requirement with respect to section 22 of the Act. SIA reasoned that, “(a)lthough the CFMA may not directly address the issue,” the policy behind the CFMA’s provision permitting FCMs to require eligible contract participant customers to waive their right to reparations, “would seem equally applicable in the case of pre-dispute arbitration agreements generally.” CL 20-4. NFA also “encourage[d] the Commission to provide more flexibility regarding pre-dispute arbitration agreements[,]” and reasoned that any restrictions on such agreements are unnecessary with respect to eligible contract participants because “[t]hese customers are capable of negotiating favorable terms in their agreements with intermediaries.” CL 16-2. Others opined that limiting the use of pre-dispute arbitration agreements for any customer contravenes prevailing law and policy regarding dispute resolution procedures. CL 11 at 2-6, CL 18 at 5-6.

SIA, FIA, and NYMEX advocated increased harmonization of the Commission’s rules governing pre-dispute arbitration agreements with those governing pre-dispute arbitration agreements in the securities industry, particularly in light of the availability of security futures products. CL 10 at 4-5, CL 11 at 5-6, CL 20 at 4; see also CL 2-9 and CL 19-7. At a minimum, FIA suggested, the Commission should exclude claims relating to security futures products from the rule’s applicability, particularly with respect to notice-registered FCMs. CL 11 at 5-6. FIA further suggested that the Commission’s rules permit FCMs to use the disclosure statement required on the securities side of a dually registered broker-dealer/FCM.<sup>60</sup>

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<sup>60</sup> FIA also specifically recommended that the Commission decline to adopt proposed rule 166.5, while removing part 180. CL 11 at 6. NFA commented that the Commission should provide that arbitration agreements bind both the customer and the intermediary equally. CL 16 at 2.

In the final rules, the Commission has decided to remove any limitation on the FCM's use of account opening pre-dispute arbitration agreements for eligible contract participants. As several commenters noted, this is consistent with the CFMA, which permits FCMs to require that eligible contract participant customers waive their right to reparations as a condition of opening an account. It also should facilitate the ability of an FCM that is also a broker-dealer to use a single agreement with those customers.<sup>61</sup> With regard to customers who are not eligible contract participants, the Commission is retaining the voluntariness requirement in its current form. However, it will further consider the issue as part of its study on the regulation of intermediaries and as part of its rules implementing the provisions of the Act relating to security futures products.

#### 4. Contract Approval Fees.

Prior to the CFMA's amendments to the Act, boards of trade were required to be designated as a contract market in each commodity that they listed for trading. The CFMA amended the Act, in part, by providing that the facility must be designated as a "contract market" or registered as a DTF, that the contract market or DTF may list new products for trading by certification, and that they may voluntarily request Commission approval of those products. The

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<sup>61</sup> A number of the above comments relating to greater harmonization of account opening disclosures to customers of dually registered FCMs/broker-dealers are outside of the scope of this rulemaking. Nevertheless, the Commission agrees that these issues are important and should be addressed, including the feasibility of using the disclosure currently mandated for securities customers for commodity customers as well. *See, e.g.*, Rule 3110(f) of the National Association of Securities Dealers, Inc.; *see also* 64 FR 66681 (Nov. 29, 1999) (Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Amendments to NASD Rule 3110(f) Governing Use of Predispute Arbitration Agreements with Customers).

Commission proposed to amend current 17 CFR, Part 5, Appendix B, to clarify that applications for voluntary product approval must be accompanied by a service fee.<sup>62</sup> No comments were received and the Commission is adopting the provision as proposed. The Commission, in a separate notice of final rulemaking published elsewhere in this edition of the Federal Register, is revising the fees charged for this service.

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

Some of the rules contained in this Federal Register notice are being adopted under section 4(c) of the Act, which grants the Commission broad exemptive authority. Section 4(c) of the Act provides that, in order to promote responsible economic or financial innovation and fair competition, the Commission may by rule, regulation or order exempt any class of agreements, contracts or transactions, either unconditionally or on stated terms or conditions, from any of the requirements of any provision of the Act (except certain provisions governing a group or index of securities and security futures products). As relevant here, when granting an exemption pursuant to section 4(c), the Commission must find that the exemption would be consistent with the public interest.

When it proposed these rules, the Commission made a preliminary determination that the exemptions contained therein would be consistent with the public interest because they provide registered entities with greater procedural flexibility than is contained in the Act. For instance,

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<sup>62</sup> The Commission also proposed to redesignate the Appendix as Appendix B to Part 40. Previously, in November 1999, the Commission proposed to eliminate fees for contract market designation applications in connection with its adoption of Rule 5.3 that allowed exchanges to list new contracts by certification (64 FR 66432, Nov. 26, 1999). The Commission deferred action while it considered additional regulatory reform.

pursuant to rule 38.4, contract markets may request approval of their contracts following certification of those contracts, notwithstanding the Act's limitation of the Commission's approval authority to “prior” approval. Furthermore, the rules contain a less burdensome certification procedure than that provided for in the Act. The Commission invited public comment on its preliminary determination that this exercise of its exemptive authority would be consistent with the public interest. As noted above, the commenters broadly supported these exemptive rules. Accordingly, the Commission finds under section 4(c) of the Act that the exemptions are consistent with the public interest.

#### **IV. Cost-Benefit Analysis**

Section 15 of the Act, as amended by section 119 of the CFMA, requires the Commission, before issuing a new regulation under the Act, to consider the costs and benefits of its action. The Commission understands that, by its terms, section 15 does not require the Commission to quantify the costs and benefits of a new regulation or to determine whether the benefits of the proposed regulation outweigh its costs. Rather, section 15 simply requires the Commission to “consider the costs and benefits” of its action.

Section 15 further specifies that costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. Accordingly, the Commission could in its discretion give greater weight to any one of the five enumerated areas of concern and could in its discretion determine that, notwithstanding its costs, a particular rule was

necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the Act.

The Commission's proposal contained an analysis of its consideration of these costs and benefits and solicited public comment thereon. 66 FR at 14267. The Commission specifically invited commenters to submit any data that they had quantifying the costs and benefits of the proposed rules with their comment letters. Id. The Commission has considered all the comment letters received, some of which contained narrative discussion of the costs and benefits of specific provisions of this rule package, but none of which set forth any data that quantified such costs and benefits.

The Commission has considered the costs and benefits of this rule package in light of the specific areas of concern identified in section 15. The Commission has endeavored in this rule package to impose the minimum requirements necessary to enable the Commission to perform its oversight functions, to carry out its mandate of assuring the continued existence of competitive and efficient markets and to protect the public interest in markets free of fraud and abuse. After considering their costs and benefits, the Commission has decided to adopt these rules as discussed above.

#### **V. Implementation Issues; No-action**

In light of Congress's intent to implement the changes of the CFMA without delay, the Commission determined when it proposed these rules that it would not bring any enforcement action against any person who complied with the proposed rules during the transition period between the effective date of the amendments to the Act (generally, December 21, 2000) and the adoption of final implementing regulations. 66 FR at 14268. At that time, the Commission also

advised persons relying on that no-action position that they would be required to bring their conduct into compliance with the final rules to the extent that the final rules differ from the proposed rules. Id.

The rules being adopted today will become effective **[insert date 60 days after publication in the Federal Register]**. The Commission will not bring any enforcement action against any person who complies with the final rules during the period between their adoption and effective date.

## **VI. Related Matters**

### **A. Regulatory Flexibility Act**

The Regulatory Flexibility Act (RFA), 5 U.S.C. 601 et seq., requires federal agencies, in promulgating rules, to consider the impact of those rules on small entities. The rules adopted herein would affect contract markets and other trading facilities. 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>63</sup> In its previous determinations, the Commission has concluded that contract markets are not small entities for the purpose of the RFA.<sup>64</sup> The Commission proposed to determine that the other trading facilities covered by these rules, for reasons similar to those applicable to contract markets, are not small entities for purposes of the RFA. 66 FR at 14268. In its proposing release, the Commission also observed that the rules authorize these trading facilities to operate in a less regulated

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<sup>63</sup> 47 FR 18618-21 (Apr. 30, 1982).

<sup>64</sup> 47 FR 18618, 18619 (discussing contract markets).

environment than may currently be the case and that, consequently, the rules should not result in, or should result in only a de minimis, increase in the regulatory requirements that apply to contract markets and other trading facilities. The Commission invited the public to comment on its proposed determination that the new categories of trading facilities covered by these rules would not be small entities for purposes of the RFA and on its finding of small entity impact. The Commission received no comments on its proposed determination or on its proposed finding.

The Commission hereby determines that the new categories of trading facilities covered by these rules (derivatives transaction execution facilities, exempt boards of trade and exempt commercial markets) are not small entities for purposes of the RFA. Furthermore, the Commission does not believe that these rules, as adopted, will have a significant economic impact on a substantial number of small entities. Therefore, the Acting Chairman, on behalf of the Commission, hereby certifies, pursuant to 5 U.S.C. 605(b), that the rule amendments will not have a significant economic impact on a substantial number of small entities.

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

This rulemaking contains information collection requirements. As required by the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 et seq.), the Commission has submitted a copy of these rules to the Office of Management and Budget for its review. See 44 U.S.C. 3507(d)(1). No comments were received in response to the Commission's invitation in the notice of proposed rulemaking to comment on any potential paperwork burden associated with these regulations. See 44 U.S.C. 3507 (d)(2).

The final rules contain several disclosure requirements. Exempt commercial markets may not represent that they are regulated (rule 36(c)). In addition, DTFs and contract markets must disclose information related to prices, bids and offers and certain trading information (part 37, Appendix B, Core Principles 4 and 5; part 38, Appendix B, Core Principles 7, 8 and 10.)

The final rules also contain several reporting requirements. Exempt boards of trade and exempt commercial markets must notify the Commission that they are engaging in business (rules 36.2(b) and 36.3(a)). Contract markets and DTFs must file applications for designation and registration, respectively, and must certify that certain rules are consistent with the Act (rules 37.5, 37.7, 38.3, 38.4, 40.2 and 40.7).

The final rules also require the collection of certain information from exempt boards of trade, exempt commercial markets, contract markets and DTFs. The Commission may not conduct or sponsor, and a person is not required to respond to an information collection unless it displays a currently valid OMB control number. The Commission has requested a control number for these information collections from OMB.

## **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 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 40

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

17 CFR Part 41

Security Futures, Commodity Futures Trading Commission.

17 CFR Part 100

Commodity futures, Commodity Futures Trading Commission.

17 CFR Part 166

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

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 Act, as amended by the Commodity Futures Modernization Act of 2000, Appendix E of Pub. L. 106-554, 114 Stat. 2763 (2000), and, in particular, sections 1a, 2, 3, 4, 4c, 4i, 5, 5a, 5b, 5c, 5d, 6 and 8a thereof, the Commission hereby amends Chapter I of Title 17 of the Code of Federal Regulations as follows:

**PART 1--GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT**

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

**Authority:** 7 U.S.C. 1a, 2, 5, 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, as amended by the

Commodity Futures Modernization Act of 2000, Appendix E of Pub. L. No. 106-554, 114 Stat. 2763 (2000).

2. Section 1.1 is revised to read follows:

**§1.1 Fraud in or in connection with transactions in foreign currency subject to the Commodity Exchange Act.**

(a) Scope. The provisions of this subsection shall be applicable to accounts, agreements, contracts, or transactions described in section 2(c)(1) of the Act, to the extent that the Commission exercises jurisdiction over such accounts, agreements, contracts and transactions as provided in section 2(c)(2)(B) of the Act (except that this section shall not be applicable to persons described in section 2(c)(2)(B)(ii)(II) or 2(c)(2)(B)(ii)(III) of the Act).

(b) Fraudulent conduct prohibited. It shall be unlawful for any person, directly or indirectly, in or in connection with any account, agreement, contract or transaction that is subject to paragraph (a) of this section:

(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 or cause to be entered for any person any false record; or

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

3. Section 1.3 is amended by revising the undesignated introductory paragraph to read as follows:

**§1.3 Definitions.**

Words used in the singular form in the rules and regulations in this chapter shall be deemed to import the plural and vice versa, as the context may require. The following terms, as used in the Commodity Exchange Act, or in the rules and regulations in this chapter, shall have the meanings hereby assigned to them, unless the context otherwise requires:

\* \* \* \* \*

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

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

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(c) Each designated contract market 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. In addition, upon request, a designated contract market shall provide to the Commission information regarding 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 designated contract market on which transactions in futures or option contracts of foreign traders are executed through, or the resulting transactions are maintained in, accounts carried by a registered futures commission merchant or introduced by a registered introducing broker subject to the provisions of paragraph (a) of this section.

5. Sections 1.41, 1.41b, 1.43, 1.45, 1.50 and 1.51 are removed and reserved.

## **PART 15--REPORTS--GENERAL PROVISIONS**

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

**Authority:** 7 U.S.C. 2, 5, 6(c), 6a, 6c(a)-(d), 6f, 6g, 6i, 6k, 6m, 6n, 7, 9, 12a, 19 and 21, as amended by the Commodity Futures Modernization Act of 2000, Appendix E of Pub. L. 106-554, 114 Stat. 2763 (2000).

7. Section 15.05 is amended by revising the heading and 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.**

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(e) Any designated contract market or registered derivatives transaction execution facility that permits a foreign broker to intermediate contracts, agreements or transactions, or permits a foreign trader to effect contracts, agreements or transactions 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 contracts, agreements or transactions executed by the foreign broker or the foreign trader on the designated contract market or registered derivatives transaction execution facility. Service or delivery of any communication issued by or on behalf of the Commission to a designated contract market or registered derivatives transaction execution facility shall constitute valid and effective service upon the foreign broker, any of its customers, or the foreign trader. A designated contract

market or registered derivatives transaction execution facility which has been served with, or to which there has been delivered, a communication issued by or on behalf of the Commission to a foreign broker, any of its customers, or a foreign trader shall transmit the communication promptly and in a manner which is reasonable under the circumstances, or in a manner specified by the Commission in the communication, to the foreign broker, any of its customers or the foreign trader.

(f) It shall be unlawful for any designated contract market or registered derivatives transaction execution facility to permit a foreign broker, any of its customers or a foreign trader to effect contracts, agreements or transactions on the facility unless the designated contract market or registered derivatives transaction execution facility prior thereto informs the foreign broker, any of its customers or the foreign trader, in any reasonable manner the facility 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 contracts, transactions or agreements traded on any designated contract market or registered derivatives transaction execution facility 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 designated contract market or registered derivatives transaction execution facility prior to effecting any contract, agreement or transaction on the facility. 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 designated contract market or registered derivatives transaction execution facility prior to permitting the foreign broker, any of its customers or the foreign trader to effect any transactions in futures or option contracts. Unless otherwise specified by the Commission, the agreements required to be filed with the Commission shall be filed with the Secretary of the Commission at Three Lafayette Centre, 1155 21st Street, N.W., Washington, D.C. 20581. A foreign broker, any of its customers or a foreign trader shall notify the Commission immediately if the written agency agreement is terminated, revoked, or is otherwise no longer in effect. If the designated contract market or registered derivatives transaction execution facility knows or should know that the agreement has expired, been terminated, or is no longer in effect, the designated contract market or registered derivatives transaction execution facility shall notify the Secretary of the Commission immediately. If the written agency agreement expires, terminates, or is not in effect, the designated contract market or registered derivatives transaction execution facility 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 designated contract market or registered derivatives transaction execution facility on which all transactions of foreign brokers, their customers or foreign traders in futures or option contracts, or other instruments subject to the Act pursuant to section 5a(g) of the Act, are executed through, or the resulting transactions are maintained in, accounts carried by a registered futures commission merchant or introduced by a registered introducing broker subject to the provisions of paragraphs (a), (b), (c) and (d) of this section.

8. Part 36 is revised to read as follows:

## **PART 36--EXEMPT MARKETS**

Sec.

36.1 Scope.

36.2 Exempt boards of trade.

36.3 Exempt commercial markets.

**Authority:** 7 U.S.C. 2, 5, 6, 6c, and 12a, as amended by the Commodity Futures Modernization Act of 2000, Appendix E of Pub. L. 106-554, 114 Stat. 2763 (2000).

### **§36.1 Scope.**

The provisions of this part apply to any board of trade or electronic trading facility eligible for exemption under sections 5d and 2(h)(3) through (5) of the Act, respectively.

### **§36.2 Exempt boards of trade.**

(a) Eligible commodities. Commodities eligible under section 5d(b)(1) of the Act to be traded by an exempt board of trade are:

- (1) Commodities having--
  - (i) A nearly inexhaustible deliverable supply;

(ii) A deliverable supply that is sufficiently large, and a cash market sufficiently liquid, to render any contract traded on the commodity highly unlikely to be susceptible to the threat of manipulation; or

(iii) No cash market.

(2) The commodities that meet the criteria of paragraph (a)(1) of this section are:

(i) The commodities defined in section 1a(13) of the Act as "excluded commodities" (other than a security, including any group or index thereof or any interest in, or based on the value of, any security or group or index of securities); and

(ii) Such other commodity or commodities as the Commission may determine by rule, regulation or order.

(b) Notification. Boards of trade operating under section 5d of the Act as exempt boards of trade shall so notify the Commission. This notification shall be filed with the Secretary of the Commission at its Washington, DC headquarters, in either electronic or hard copy form, shall be labeled as "Notification of Operation as Exempt Board of Trade," and shall include:

(1) The name and address of the exempt board of trade; and

(2) The name and telephone number of a contact person.

(c) Additional requirements. (1) A board of trade notifying the Commission that it meets the criteria of section 5d of the Act and elects to operate as an exempt board of trade shall not represent to any person that it is registered with, designated, recognized, licensed or approved by the Commission.

(2) If the Commission finds by order, after notice and an opportunity for a hearing through submission of written data, views and arguments, that the facility serves as a significant source for the discovery of prices in the cash market for the underlying commodity, the facility must on a daily basis disseminate publicly trading volume, opening and closing price ranges, open interest and other trading data to the extent appropriate to that market with respect to transactions executed in reliance on the exemption as specified in the order.

### **§36.3 Exempt commercial markets.**

(a) Notification. An electronic trading facility relying upon the exemption in section 2(h)(3) of the Act shall notify the Commission of its intention to do so. This notification, and subsequent notification of any material changes in the information initially provided, shall be filed with the Secretary of the Commission at its Washington, DC headquarters, in either electronic or hard copy form, shall be labeled as “Notification of Operation as Exempt Commercial Market,” and shall include the information and certifications specified in section 2(h)(5)(A) of the Act.

(b) Required information. (1) A facility operating in reliance on the exemption in section 2(h)(3) of the Act, initially and on an on-going basis, must:

(i) Provide the Commission with access to the facility's trading protocols and electronic access to transactions conducted on the facility in reliance on such exemption; or

(ii) Attach its initial trading protocols and any amendments thereto in hard copy form to the notification required in paragraph (a) of this section and provide in a form and manner acceptable to the Commission, as determined by the Commission in response to a petition by the

exempt market relying upon the exemption in section 2(h)(3) of the Act, information regarding transactions by large traders on the facility.

(2) Special calls. (i) All information required upon special call of the Commission under section 2(h)(5)(B)(iii) of the Act shall be prepared in the form and manner and in accordance with the instructions, and shall be transmitted at the time and to the office of the Commission, as may be specified in the call.

(ii) The Commission hereby delegates, until the Commission orders otherwise, the authority to make special calls as set forth in section 2(h)(5)(B)(iii) of the Act to the Director of the Division of Trading and Markets and to the Director of Economic Analysis to be exercised by either Director or by such other employee or employees as the Director may designate. The directors 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.

(3) Subpoenas to foreign persons. A foreign person whose access to a trading facility is limited or denied at the direction of the Commission based on the Commission's belief that the foreign person has failed timely to comply with a subpoena as provided under section 2(h)(5)(C)(ii) of the Act shall have an opportunity for a prompt hearing under the procedures provided in §§21.03(g) and (h) of this chapter.

(c) Additional requirements. (1) An electronic trading facility relying upon the exemption in section 2(h)(3) of the Act shall not represent to any person that it is registered with, designated, recognized, licensed or approved by the Commission.

(2) If the Commission finds by order, after notice and an opportunity for a hearing through submission of written data, views and arguments, that the facility performs a significant price discovery function for transactions in the cash market for the underlying commodity, the facility must disseminate publicly price, trading volume and other trading data to the extent appropriate with respect to transactions executed in reliance on the exemption as specified in the order.

(3) The facility must represent in the notification provided under paragraph (a) of this section that it requires, and require, that each participant agree to comply with all applicable law and the facility must have a reasonable basis for believing that authorized participants are “eligible commercial entities” as defined in section 1a(11) of the Act.

9. Part 37 is added to read as follows:

## **PART 37--DERIVATIVES TRANSACTION EXECUTION FACILITIES**

Sec.

37.1 Scope and definition.

37.2 Exemption.

37.3 Requirements for underlying commodities.

37.4 Election to trade excluded and exempt commodities.

37.5 Procedures for registration.

37.6 Compliance with core principles.

37.7 Additional requirements.

37.8 Information relating to transactions on derivative transaction execution facilities.

37.9 Enforceability.

Appendix A to Part 37--Application Guidance

Appendix B to Part 37--Guidance on Compliance with Core Principles

**Authority:** 7 U.S.C. 2, 5, 6, 6c, 6(c), 7a and 12a, as amended by the Commodity Futures Modernization Act of 2000, Appendix E of Pub. L. 106-554, 114 Stat. 2763 (2000).

### **§37.1 Scope and definition.**

(a) Scope. The provisions of this part apply to any board of trade or trading facility operating as a registered derivatives transaction execution facility.

(b) Definition. As used in this part, the term “eligible commercial entity” means, and shall include, in addition to a party or entity so defined in section 1a(11) of the Act, a registered floor trader or floor broker trading for its own account, whose trading obligations are guaranteed by a registered futures commission merchant.

### **§37.2 Exemption.**

Contracts, agreements or transactions traded on a derivatives transaction execution facility registered as such with the Commission under section 5a of the Act, the facility and the facility's operator are exempt from all Commission regulations for such activity, except for the requirements of this part 37 and §§1.3, 1.31, 1.59(d), 1.63(c), 15.05, 33.10, part 40 and part 190

of this chapter, and as applicable to the market, parts 15 through 21 of this chapter, which are applicable to a registered derivatives transaction execution facility as though they were set forth in this section and included specific reference to derivatives transaction execution facilities.

### **§37.3 Requirements for underlying commodities.**

(a) Trading facilities limited to eligible traders. Trading facilities limited to eligible traders as defined by section 5a(b)(3) of the Act, may trade any contract of sale of a commodity for future delivery (or option on such a contract) on any of the following underlying commodities:

- (1) Commodities having--
  - (i) A nearly inexhaustible deliverable supply;
  - (ii) A deliverable supply that is sufficiently large that the contract is highly unlikely to be susceptible to the threat of manipulation; or
  - (iii) No cash market;
- (2) Commodities that are a security futures product, and the registered derivatives transaction execution facility is a national securities exchange registered under the Securities Exchange Act of 1934;
- (3) Commodities for which the Commission has determined, based on the market characteristics and surveillance history, and the self-regulatory record and capacity of the facility, that trading in the contract (or option) based on that commodity is highly unlikely to be susceptible to the threat of manipulation; or

(4) Commodities that are agricultural commodities enumerated in section 1a(4) of the Act that have been so approved by the Commission under the procedures of paragraph (c) of this section.

(5) The commodities that meet the criteria of paragraph (a)(1) of this section are the commodities defined in section 1a(13) of the Act as “excluded commodities.”

(6) The Commission may make the determination described in paragraph (a)(3) of this section by rule, regulation or order, after notice and an opportunity for a hearing through submission of written data, views and arguments. A registered derivatives transaction execution facility may request that the Commission make such an individualized determination by filing with the Secretary of the Commission at its Washington, DC headquarters a petition that includes:

(i) The terms and conditions of the product to be listed; and

(ii) A demonstration, supported by data, that the underlying commodity has a sufficiently liquid and deep cash market and a surveillance history based on actual trading experience and in light of any self-regulatory undertakings of the facility, to provide assurance that the contract or product is highly unlikely to be manipulated. The demonstration should address the following specific factors to the extent that the factor is not self-evident:

(A) A high level of cash-market liquidity;

(B) Cash-market bid-ask spreads that are narrow relative to traded values;

(C) Relatively frequent cash market transactions involving participants that represent major segments of the industry;

(D) The absence of material impediments to participation in the cash market by commercial entities;

(E) Transfer of ownership of the cash commodity that is easily and readily accomplished at minimal cost;

(F) A pattern of cash market pricing that exhibits continuity and the absence of frequent, sharp price changes such that a person cannot readily move materially the price of the product in normal cash market channels;

(G) A history of actual trading experience that the contract or product's terms and conditions provide for a deliverable supply, or a reliable and acceptable cash-settlement procedure, that is adequate to minimize the threat of market abuses such as price manipulation and distortions, congestion, and defaults; and

(H) Procedures to effectively oversee the market, including a large trader reporting system, as well as a history of active surveillance to prevent or mitigate market problems.

(b) Trading facilities limited to eligible commercial entities. Any commodity, other than the agricultural commodities enumerated in section 1a(4) of the Act, is eligible under section 5a(b)(2)(F) of the Act to be traded on a derivatives transaction execution facility that limits participants on the facility to eligible commercial entities as defined by §37.1(b) trading

for their own account. Provided, however, an agricultural commodity enumerated in section 1a(4) of the Act may be so approved by the Commission under the procedures of paragraph (c) of this section.

(c) Enumerated agricultural commodities. [Reserved]

#### **§37.4 Election to trade excluded and exempt commodities.**

A board of trade that is or elects to become a registered derivatives transaction execution facility may, pursuant to section 5a(g) of the Act, trade agreements, contracts, or transactions that are excluded or exempt from the Act pursuant to sections 2(c), 2(d), 2(g), or 2(h).

#### **§37.5 Procedures for registration.**

(a) Notification by contract markets. To operate as a registered derivatives transaction execution facility pursuant to section 5a of the Act, a board of trade, facility or entity that is designated as a contract market, must:

(1) Comply with the core principles for operation under section 5a(d) of the Act and the provisions of this part 37; and

(2) Notify the Commission of its intent to so operate by filing with the Secretary of the Commission at its Washington, DC headquarters a copy of the facility's rules (which may be trading protocols) or a list of the designated contract market's rules that apply to operation of the derivatives transaction execution facility, and a certification by the contract market that it meets:

(i) The requirements for trading of section 5a(b) of the Act; and

(ii) The criteria for registration under section 5a(c) of the Act.

(b) Registration by application. A board of trade, facility or entity shall be deemed to be registered as a derivatives transaction execution facility thirty days after receipt by the Commission of an application for registration as a derivatives transaction execution facility unless notified otherwise during that period, or, as determined by Commission order, registered upon conditions, if:

(1) The application demonstrates that the applicant satisfies the requirements for trading and the criteria for registration of sections 5a(b) and 5a(c) of the Act, respectively;

(2) The submission is labeled “Application for DTF Registration”;

(3) The submission includes:

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

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

(iii) To the extent that compliance with the requirements for trading or the criteria for recognition is not self-evident, a brief explanation of how the rules or trading protocols satisfy each of the conditions for registration;

(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;

(5) The applicant identifies with particularity information in the application that will be subject to a request for confidential treatment and supports that request for confidential treatment with reasonable justification; and

(6) The applicant has not instructed the Commission in writing at the time of submission of the application or during the review period to review the application pursuant to the time provisions of and procedures under section 6 of the Act.

(c) Guidance for applicants. Appendix A to this part provides guidance to applicants for registration as a derivatives transaction execution facility on how the conditions for registration in sections 5a(b) and 5a(c) of the Act could be satisfied.

(d) Termination of fast track review. During the thirty-day period for review pursuant to paragraph (b) of this section, the Commission shall notify the applicant seeking registration that the Commission is terminating review under this section and will review the proposal under the time period and procedures of section 6 of the Act, if it appears that the application's form or substance fails to meet the requirements of this part. This termination notification will state the nature of the issues raised and the specific condition of registration that the applicant would violate, appears to violate, or the violation of which cannot be ascertained from the application. Within ten days of receipt of this termination notification, the applicant seeking registration may request that the Commission render a decision whether to register the derivatives transaction execution facility or to institute a proceeding to deny the proposed application under procedures

specified in section 6 of the Act by notifying the Commission that the applicant seeking registration views its submission as complete and final as submitted.

(e) Request for withdrawal of application for registration or withdrawal of registration. An applicant to be registered, or a registered derivatives transaction execution facility may withdraw its application or its registration by filing with the Commission at its Washington, DC, headquarters such a request. Withdrawal from registration 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 application for registration was pending with, or that the facility was registered by, the Commission.

(f) Delegation of authority.

(1) The Commission hereby delegates, until it orders otherwise, to the Director of the Division of Trading and Markets and separately to the Director of Economic Analysis or such other employee or employees as the Directors may designate from time to time, with the concurrence of the General Counsel or the General Counsel's delegatee, authority to exercise the functions provided under paragraph (b) of this section.

(2) The directors may submit to the Commission for its consideration any matter that has been delegated in this paragraph.

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

### **§37.6 Compliance with core principles.**

(a) In general. To maintain registration as a derivatives transaction execution facility upon commencing operations by listing products for trading or otherwise and on a continuing basis thereafter, the derivatives transaction execution facility must have the capacity to be, and be, in compliance with the core principles of section 5a(d) of the Act.

(b) New derivatives transaction execution facilities. (1) Certification of compliance. Unless an applicant for registration has chosen to make a voluntary demonstration under paragraph (b)(2) of this section, a newly registered derivatives transaction execution facility at the time it commences operations must certify to the Commission that it has the capacity to, and will, operate in compliance with the core principles under section 5a(d) of the Act.

(2) Voluntary demonstration of compliance. An applicant for registration may choose to make a voluntary demonstration of its capacity to operate in compliance with the core principles as follows:

(i) At least thirty days prior to commencing operations, the applicant for registration must file with the Secretary of the Commission at its Washington, D.C. headquarters, either separately or with the application required by §37.4, a submission that includes:

(A) The label, “Demonstration of Compliance with Core Principles for Operation;”

(B) The derivatives transaction execution facility's rules, which may be trading protocols, that enable or empower the facility to comply with the core principles;

(C) Any agreements entered into or to be entered into between or among the facility, its operator or its participants that enable or empower the facility to comply with the core

principles, including where applicable, technical manuals and other guides or instructions for users of the facility; and

(D) To the extent that capacity to comply with a core principle is not self-evident, a brief explanation of how the facility has the capacity to meet the core principle.

(ii) Unless the applicant requests an extension of time, the applicant shall be deemed to have demonstrated its capacity to comply with the core principles thirty days after receipt by the Commission, unless notified otherwise.

(iii) If it appears that the applicant has failed to make the requisite showing, the Commission will so notify the applicant at the end of that period. Upon commencement of operations by the derivatives transaction execution facility, such a notice may be considered by the Commission in a determination to issue a notice of violation of core principles under section 5c(d) of the Act.

(c) Existing derivatives transaction execution facilities. Upon request by the Commission, a registered derivatives transaction execution facility shall file with the Commission such data, documents and other information as the Commission may specify in its request that demonstrates that the registered derivatives transaction execution facility is in compliance with one or more core principles as specified in the request or that is requested by the Commission to enable the Commission to satisfy its obligations under the Act.

(d) Guidance regarding compliance with core principles. A derivatives transaction execution facility may meet the following core principles of section 5a(d) of the Act as specified in this paragraph:

(1) Compliance with rules. The core principle regarding compliance with rules under section 5a(d)(2) of the Act may be met, as appropriate to the facility, through the effective monitoring of limitations on access to the facility;

(2) Monitoring of trading. The core principle regarding monitoring of trading under section 5a(d)(3) of the Act may be met, as appropriate to the market and the products traded thereon, by providing information to the Commission as requested to satisfy the Commission's obligations under the Act;

(3) Disclosure of general information. The core principle regarding disclosure of general information relevant to participation in trading on the facility under section 5a(d)(4)(D) of the Act also includes providing to market participants on a fair, equitable and timely basis information regarding, as appropriate to the market, prices, bids and offers, and such other information that the Commission may determine by rule, regulation or order, after notice and an opportunity for a hearing through submission of written data, views and arguments;

(4) Daily publication of trading information. The Commission will determine by order, after notice and an opportunity for a hearing through submission of written data, views and arguments, whether the requirement of the core principle on publication of trading information under section 5a(d)(5) of the Act applies to a particular product or products traded on a facility;

(5) Fitness. Appropriate minimum standards for participants having direct access to the facility under the core principle on fitness pursuant to section 5a(d)(6) of the Act also includes natural persons that directly or indirectly have greater than a ten percent ownership interest in the facility; and

(6) In general. Appendix B to this part provides guidance to registered derivatives transaction execution facilities on how the core principles under section 5a(d) of the Act could be satisfied.

### **§37.7 Additional requirements.**

(a) Products. Notwithstanding the provisions of section §5c(c) of the Act and §40.2 of this chapter, derivatives transaction execution facilities need only notify the Commission of the listing of new products for trading, posting of new product descriptions, terms and conditions or trading protocols or providing for a new system product functionality, by filing with the Secretary of the Commission at its Washington, D.C. headquarters, a submission labeled “DTF Notice of Product Listing” that includes the text of the product's terms or conditions, product description, trading protocol or description of the system functionality or by electronic notification of the foregoing at the time traders or participants in the market are notified, but in no event later than the close of business on the business day preceding initial listing, posting or implementation of the trading protocol or system functionality.

(b) Material modifications. Notwithstanding the provisions of section 5c(c) of the Act, registered derivatives transaction execution facilities need not certify rules or rule amendments under §40.6 of this chapter, and must only notify the Commission prior to placing into effect or amending such a rule, which includes trading protocols, by:

(1) Filing with the Secretary of the Commission at its Washington, D.C. headquarters at the time traders or participants in the market are notified, but (unless taken as an emergency action) in no event later than the close of business on the business day preceding implementation

of the rule, a submission labeled, “DTF Rule Notice.” The submission shall include the text of the rule or rule amendment (deletions and additions must be indicated); or

(2) By electronic notification to the Commission of the rule to be placed into effect or to be changed, in a format approved by the Secretary of the Commission, at the time traders or participants in the market are notified, but (unless taken as an emergency action) in no event later than the close of business on the business day preceding implementation. Provided, however, the derivatives transaction execution facility need not notify the Commission of rules or rule amendments for which no certification is required under §40.6(c) of this chapter.

(3) The derivatives transaction execution facility must maintain documentation regarding all changes to rules, terms and conditions or trading protocols.

(c) Voluntary request for Commission approval of rules or products. (1) A board of trade or trading facility seeking to be registered as, or registered as, a derivatives transaction execution facility, may request that the Commission approve under section 5c(c) of the Act, 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, prior to their implementation or, notwithstanding the provisions of section 5c(c)(2) of the Act, at anytime thereafter, under the procedures of §§40.5 or 40.3 of this chapter, as applicable. A derivatives transaction execution facility may label a product in its rules as, “Listed for trading pursuant to Commission approval,” if the product and its terms or conditions have been approved by the Commission and it may label as, “Approved by the Commission,” only those rules that have been so approved.

(2) Notwithstanding the forty-five day review period for voluntary approval under §40.3(b) of this chapter, the operating rules and the terms and conditions of one product

submitted for voluntary Commission approval under §40.3 of this chapter, that has been submitted with, and at the same time as, an application for registration as a derivatives transaction execution facility, will be deemed approved by the Commission thirty days after receipt by the Commission , or at the conclusion of such extended period as provided under §40.3(c) of this chapter.

(3) An applicant for registration, or a registered derivatives transaction execution facility may request that the Commission consider under the provisions of section 15(b) of the Act any of the derivatives transaction execution facility's rules or policies, including both operational rules and the terms or conditions of products listed for trading, at the time of registration or thereafter.

(d) Identify participants. Registered derivatives transaction execution facilities must 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. In addition, upon request, a derivatives transaction execution facility shall provide to the Commission information regarding the name of any person exercising control over the trading of such foreign trader. Provided, however, this paragraph shall not apply to a derivatives transaction execution facility insofar as transactions in futures or option contracts of foreign traders are executed through, or the resulting transactions are maintained in accounts carried by, a registered futures commission merchant or introduced by an introducing broker subject to §1.37 of this chapter.

(e) Identify persons subject to fitness requirement. Upon request by any representative of the Commission, a registered derivatives transaction execution facility shall

furnish to the Commission's representative a current list of persons subject to the fitness requirements of section 5a(d)(6) of the Act.

**§37.8 Information relating to transactions on derivatives transaction execution facilities.**

(a) Special calls for information from derivatives transaction execution facilities.

Upon special call by the Commission, a registered derivatives transaction execution facility shall provide to the Commission such information related to its business as a derivatives transaction execution facility, including information relating to data entry and trade details, in the form and manner and within the time as specified by the Commission in the special call.

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

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

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

### **§37.9 Enforceability.**

An agreement, contract or transaction entered into on, or pursuant to the rules of, a registered derivatives transaction execution facility shall not be void, voidable, subject to rescission or otherwise invalidated or rendered unenforceable as a result of:

(a) A violation by the registered derivatives transaction execution facility of the provisions of section 5a of the Act or this part 37; or

(b) Any Commission proceeding to alter or supplement a rule, term or condition under section 8a(7) of the Act or any other proceeding the effect of which is to disapprove, alter, supplement, or require a registered derivatives transaction execution facility to adopt a specific term or condition, trading rule or procedure, or to take or refrain from taking a specific action.

### **Appendix A to Part 37--Application Guidance**

This appendix provides guidance to applicants for registration as derivatives transaction execution facilities under sections 5a(c) and 6 of the Act and § 37.5, on meeting the criteria for

registration both initially and on an ongoing basis. The guidance following each registration criterion is illustrative only of the types of matters an applicant may address, as applicable, and is not intended to be a mandatory checklist. Addressing the issues and questions set forth in this appendix would help the Commission in its consideration of whether the application has met the criteria for registration. To the extent that compliance with, or satisfaction of, a criterion for registration is not self-explanatory from the face of the derivatives transaction execution facility's rules, which may be terms and conditions or trading protocols, the application should include an explanation or other form of documentation demonstrating that the applicant meets the registration criteria of section 5a(c) of the Act and § 37.5.

Registration Criterion 1 of section 5a(c) of the Act: IN GENERAL--To be registered as a registered derivatives transaction execution facility, the board of trade shall be required to demonstrate to the Commission only that the board of trade meets the criteria specified in section 37.5(b) of this subsection.

A board of trade preparing to submit to the Commission an application to operate as a registered derivatives transaction execution facility is encouraged to contact Commission staff for guidance and assistance in preparing its application. Applicants may submit a draft application for review prior to the submission of an actual application without triggering the application review procedures of § 37.5.

Registration Criterion 2 of section 5a(c) of the Act: DETERRENCE OF ABUSES--The board of trade shall establish and enforce trading and participation rules that will deter abuses and has the capacity to detect, investigate, and enforce those rules, including means to--(A) obtain information necessary to perform the functions required under this section; or (B) use technological means to--(i) provide market participants with impartial access to the market; and (ii) capture information that may be used in establishing whether rule violations have occurred.

An application of a board of trade to operate as a registered derivatives transaction execution facility should include arrangements and resources to deter abuses by effective and affirmative rule enforcement, including documentation of the facility's authority to do so; such trading and participation rules should be designed with adequate specificity. The submission should include documentation on the ability of the facility either to obtain necessary information or to provide market participants with impartial access and capture information for use in establishing possible rule violations.

Registration Criterion 3 of section 5a(c) of the Act: TRADING PROCEDURES--The board of trade shall establish and enforce rules or terms and conditions defining, or specifications detailing, trading procedures to be used in entering and executing orders traded on the facilities of the board of trade. The rules may authorize--(A) transfer trades or office trades; (B) an exchange of--(i) futures in connection with a cash commodity transaction; (ii) futures for cash commodities; or (iii) futures for swaps; or (C) a futures commission merchant, acting as principal or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if the contract is reported, recorded, or cleared in accordance with the rules of the registered derivatives transaction execution facility or a derivatives clearing organization.

(a) A submission of a board of trade to operate as an electronic registered derivatives transaction execution facility should include the system's trade-matching algorithm and order entry procedures. A submission involving a trade-matching algorithm that is based on order priority factors other than on a best price/earliest time basis should include a brief explanation of the alternative algorithm.

(b) A board of trade's specifications on initial and periodic objective testing and review of proper system functioning, adequate capacity, and security for any automated systems should be included in its submission. 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”), and adopted by the Commission on November 21, 1990 (55 FR 48670), as supplemented in October 2000, are appropriate guidelines for an electronic trading facility to apply to electronic trading systems. Any program of objective testing and review of the system should be performed by a qualified independent professional (but not necessarily a third-party contractor).

(c) A registered derivatives transaction execution facility that authorizes transfer trades or office trades, an exchange of futures for physicals or futures for swaps, or any other non-competitive transactions, including block trades, should have rules particularly authorizing such transactions and establishing appropriate recordkeeping requirements. Block trading rules should ensure that the block trading does not operate in a manner that compromises the integrity of the prices or price discovery on the relevant market.

Registration Criterion 4 of section 5a(c) of the Act: FINANCIAL INTEGRITY OF TRANSACTIONS--The board of trade shall establish and enforce rules or terms and conditions providing for the financial integrity of transactions entered on or through the facilities of the board of trade, and rules or terms and conditions to ensure the financial integrity of any futures commission merchants and introducing brokers and the protection of customer funds.

(a) A board of trade operating as a registered derivatives transaction execution facility should provide for the financial integrity of transactions by setting appropriate minimum financial standards for members and non-intermediated market participants, appropriate margin forms, and appropriate default rules and procedures. If cleared, agreements, contracts and transactions in excluded or exempt commodities that are traded on a DTF may be cleared through clearing organizations other than DCOs registered with the Commission. The Commission believes ensuring and enforcing the financial integrity of transactions and intermediaries, and the

protection of customer funds should include monitoring compliance with the facility's minimum financial standards. In order to monitor for minimum financial requirements, a facility should routinely receive and promptly review financial and related information.

(b) A registered derivatives transaction execution facility that allows customers that qualify as “eligible traders” under the definition found in section 5a(b)(3) of the Act only by trading through a registered futures commission merchant pursuant to section 5a(b)(3)(B), should have rules concerning the protection of customer funds that address appropriate minimum financial standards for intermediaries, the segregation of customer and proprietary funds, the custody of customer funds, the investment standards for customer funds, related recordkeeping procedures and related intermediary default procedures.

## **Appendix B to Part 37--Guidance on Compliance With Core Principles**

1. This appendix provides guidance concerning the core principles with which a registered derivatives transaction execution facility must comply to maintain registration under section 5a(d) of the Act and § 37.5(a). This guidance is illustrative only and is not intended to be a mandatory checklist.

2. If a registered derivatives transaction execution facility chooses to certify that it has the capacity to, and upon initiation will, operate in compliance with the core principles under section 5a(d) of the Act and § 37.6, it should consider the issues set forth in this appendix prior to certification.

3. Alternatively, if a registered derivatives transaction execution facility chooses pursuant to § 37.6(b)(2) to provide the Commission with a demonstration of its compliance with core principles, addressing the issues set forth in this appendix would help the Commission in its consideration of such compliance. To the extent that compliance with, or satisfaction of, the core principles is not self-explanatory from the face of the derivatives transaction execution facility's rules, which may be terms and conditions or trading protocols, a submission under § 37.6(b)(2) should include an explanation or other form of documentation demonstrating that the derivatives transaction execution facility complies with the core principles.

Core Principle 1 of section 5a(d) of the Act: IN GENERAL--To maintain the registration of a board of trade as a derivatives transaction execution facility, a board of trade shall comply with the core principles specified in this subsection.

The board of trade shall have reasonable discretion in establishing the manner in which the board of trade complies with the core principles. A board of trade newly registered to operate as a derivatives transaction execution facility must certify or satisfactorily demonstrate its capacity to operate in compliance with the core principles under section 5a(d) of the Act prior to the commencement of its operations. The Commission also may require that a board of trade operating as a registered derivatives transaction execution facility demonstrate to the Commission that it is operating in compliance with one or more core principles.

Core Principle 2 of section 5a(d) of the Act: COMPLIANCE WITH RULES--The board of trade shall monitor and enforce the rules of the facility, including any terms and conditions of any contracts traded on or through the facility and any limitations on access to the facility.

(a) A board of trade operating as a registered derivatives transaction execution facility should have arrangements, resources and authority to detect and deter abuses by effectively and affirmatively enforcing its rules (which, in the case of a facility that restricts traders to eligible commercial entities, may be the effective monitoring of limitations on access to the facility), 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, limit or suspend, and/or terminate activities or access of a member, including members with trading privileges but having no, or only nominal equity, in the facility and non-member market participants or, in the case of a derivatives transaction execution facility restricting its traders to eligible commercial entities, the authority and ability to terminate activities or access of such a member. In either case, any termination should be carried out pursuant to clear and fair standards that are available and transparent to the member or market participant.

Core Principle 3 of section 5a(d) of the Act: MONITORING OF TRADING--The board of trade shall monitor trading in the contracts of the facility to ensure orderly trading in the contract and to maintain an orderly market while providing any necessary trading information to the Commission to allow the Commission to discharge the responsibilities of the Commission under the Act.

(a) Arrangements and resources to detect and deter abuses through effective trade monitoring programs should facilitate, on both a routine and nonroutine basis, direct supervision of the market. Appropriate objective testing and review of any automated systems should occur initially and periodically to ensure proper system functioning, adequate capacity and security.

The analysis of data collected should be suitable for the type of information collected and should occur in a timely fashion. A board of trade operating as a registered derivatives transaction execution facility should have the authority to collect the information and documents necessary to reconstruct trading for appropriate market analysis as it carries out its programs to ensure orderly trading and to maintain an orderly market. The facility also should have the authority to intervene as necessary to maintain an orderly market.

(b) Alternatively, if a board of trade operating as a registered derivatives transaction execution facility restricts contracts traded to those under §§ 37.3(a)(1) and 37.3(b), it may choose to satisfy this core principle by providing information to the Commission as requested by the Commission to satisfy its obligations under the Act. The facility should have the authority to collect or capture and retrieve all necessary information.

Core Principle 4 of section 5a(d) of the Act: DISCLOSURE OF GENERAL INFORMATION--  
The board of trade shall disclose publicly and to the Commission information concerning--(A)  
contract terms and conditions; (B) trading conventions, mechanisms, and practices; (C) financial  
integrity protections; and (D) other information relevant to participation in trading on the facility.

The Commission considers that the public disclosure of information required under the core principle refers to disclosure to market participants, where the facility's user agreement requires all market participants to keep such information confidential. A board of trade operating as a registered derivatives transaction execution facility should have arrangements and resources for the disclosure and explanation of contract terms and conditions, trading conventions, trading mechanisms, trading practices, system functioning, system capacity, and financial integrity protections, including whether eligible contract participants will have the right to opt out of segregation of customer funds. Such information may be made publicly available

through the derivatives transaction execution facility's website. The facility should also, as appropriate to the market, make information regarding prices, bids and offers, or other information as determined by the Commission, readily available to market participants on a fair, equitable and timely basis. Furthermore, the facility should make available information concerning steps taken by the facility in response to an emergency.

Core Principle 5 of section 5a(d) of the Act: DAILY PUBLICATION OF TRADING INFORMATION--The board of trade shall make public daily information on settlement prices, volume, open interest, and opening and closing ranges for contracts traded on the facility if the Commission determines that the contracts perform a significant price discovery function for transactions in the cash market for the commodity underlying the contracts.

A board of trade operating as a registered derivatives transaction execution facility should provide to the public information regarding settlement prices, price range, trading volume, open interest and other related market information for all applicable contracts, as determined by the Commission. The Commission will determine by order, after notice and an opportunity for a hearing through submission of written data, views and arguments, whether the requirement of the core principle on publication of trading information under section 5a(d)(5) of the Act applies to a particular product or products traded on a facility. Provision of information for any applicable contract could be through such means as providing the information to a financial information service or by timely placing the information on a facility's website.

Core Principle 6 of section 5a(d): FITNESS STANDARDS--The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members, and any other persons with direct access to the facility, including any parties affiliated with any of the persons described in this paragraph.

A derivatives transaction execution facility should have appropriate eligibility criteria for the categories of persons set forth in the core principle that would include standards for fitness

and for the collection and verification of information supporting compliance with such standards. Minimum standards of fitness for persons who have member voting privileges, governing obligations or responsibilities, or who exercise disciplinary authority are those bases for refusal to register a person under section 8a(2) of the Act. In addition, persons who have governing obligations or responsibilities, or who exercise disciplinary authority, should not have a significant history of serious disciplinary offenses, such as those that would be disqualifying under § 1.63 of this chapter. Eligible contract participants or eligible commercial entities who are members but do not have these privileges, obligations, responsibilities or disciplinary authority could satisfy minimum fitness standards by meeting the standards that they must meet to qualify under the Act's respective definitions of eligible contract participants or eligible commercial entities. Natural persons who directly or indirectly have greater than a ten percent ownership interest in a facility should meet the fitness standards applicable to members with voting rights. A demonstration of the fitness of the applicant's directors, members, or natural persons who directly or indirectly have greater than a ten percent ownership interest in a facility 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 7 of section 5a(d) of the Act: CONFLICTS OF INTEREST--The board of trade shall establish and enforce rules to minimize conflicts of interest in the decision making process of the derivatives transaction execution facility and establish a process for resolving such conflicts of interest.

The means to address conflicts of interest in decision-making of a board of trade operating as a registered derivatives transaction execution facility should include methods to ascertain the presence of conflicts of interest and to make decisions in the event of such a

conflict. The Commission also believes that a board of trade operating as a registered derivatives transaction execution facility should provide for appropriate limitations on the use or disclosure of material non-public information gained through the performance of official duties by board members, committee members and facility employees or gained through an ownership interest in the facility.

Core Principle 8 of section 5a(d) of the Act: RECORDKEEPING--The board of trade shall maintain records of all activities related to the business of the derivatives transaction execution facility in a form and manner acceptable to the Commission for a period of 5 years.

Section 1.31 of this chapter governs recordkeeping obligations under the Act and the Commission's regulations thereunder. In order to provide broad flexible performance standards for recordkeeping, § 1.31 was updated and amended by the Commission in 1999. Accordingly, § 1.31 itself establishes the guidance regarding the form and manner for keeping records.

Core Principle 9 of section 5a(d) of the Act: ANTITRUST CONSIDERATIONS--Unless necessary or appropriate to achieve the purposes of this Act, the board of trade shall endeavor to avoid--(A) adopting any rules or taking any actions that result in any unreasonable restraint of trade; or (B) imposing any material anticompetitive burden on trading on the derivatives transaction execution facility.

A board of trade seeking to operate as a registered derivatives transaction execution facility may request that the Commission consider under the provisions of section 15(b) of the Act any of the board of trade's rules, which may be trading protocols or policies, and including both operational rules and the terms or conditions of products listed for trading, at the time it submits its registration application or thereafter. The Commission intends to apply section 15(b) of the Act to its consideration of issues under this core principle in a manner consistent with that previously applied to contract markets.

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

**PART 38--DESIGNATED CONTRACT MARKETS**

Sec.

38.1 Scope.

38.2 Exemption.

38.3 Procedures for designation by application.

38.4 Procedures for listing products and implementing contract market rules.

38.5 Information relating to contract market compliance.

38.6 Enforceability.

Appendix A to Part 38--Application Guidance

Appendix B to Part 38--Guidance on, and Acceptable Practices in, Compliance with Core Principles

**Authority:** 7 U.S.C. 2, 5, 6, 6c, 7 and 12a, as amended by the Commodity Futures Modernization Act of 2000, Appendix E of Pub. L. 106-554, 114 Stat. 2763 (2000).

**§38.1 Scope.**

The provisions of this part 38 shall apply to every board of trade or trading facility 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 to operate under the provisions of parts 36 or 37 of this chapter.

### **§38.2 Exemption.**

Agreements, contracts, or transactions traded on a designated contract market under section 6 of the Act, the contract market and the contract market's operator are exempt from all Commission regulations for such activity, except for the requirements of this part 38 and §§1.3, 1.12(e), 1.31, 1.38, 1.52, 1.59(d), 1.63(c), 1.67, 33.10, part 9, parts 15 through 21, part 40, and part 190 of this chapter.

### **§38.3 Procedures for designation by application.**

(a) Application. A board of trade or trading facility shall be deemed to be designated as a contract market sixty days after receipt by the Commission of an application for designation unless notified otherwise during that period, or, as determined by Commission order, designated upon conditions, if:

(1) The application demonstrates that the applicant satisfies the criteria for designation of section 5(b) of the Act, the core principles for operation under section 5(d) of the Act and the provisions of this part 38;

(2) The application is labeled as being submitted pursuant to this part 38;

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

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

(5) The applicant identifies with particularity information in the application that will be subject to a request for confidential treatment and supports that request for confidential treatment with reasonable justification; and

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

(b) Guidance regarding application for designation. An applicant for contract market designation may meet the following conditions for designation as specified in this paragraph:

(1) Prevention of market manipulation. The designation criterion to prevent market manipulation under section 5(b)(2) of the Act also includes the requirement that the designated contract market have a dedicated regulatory department, or delegation of that function;

(2) Fair and equitable trading. The designation criterion requiring fair and equitable trading rules under section 5(b)(3) of the Act also includes fair, equitable and timely availability to market participants of information regarding, as appropriate to the market, prices, bids and offers;

(3) Disciplinary procedures. The designation criterion to enforce disciplinary procedures under section 5(b)(6) of the Act may be satisfied by an organized exchange or a trading facility with respect to members with trading privileges but having no, or only nominal,

equity in the facility and non-member market participants of the contract market by expelling or by denying future access, either directly or indirectly, to such a person found to have violated the contract market's rules;

(4) Governance fitness standards. The requirement to establish appropriate minimum fitness standards for participants having direct access to the facility, under the core principle on fitness pursuant to section 5(d)(14) of the Act, includes natural persons that directly or indirectly have greater than a ten percent ownership interest in the facility; and

(5) In general. Appendix A to this part provides guidance to applicants for designation as contract markets on how the criteria for designation under section 5(b) of the Act can be satisfied and Appendix B to this part provides guidance to applicants for designation and designated contract markets on how the core principles of section 5(d) of the Act can be satisfied;

(c) Termination of fast track review. During the sixty-day period for review pursuant to paragraph (a) of this section, the Commission shall notify the applicant seeking designation that the Commission is terminating review under this section and will review the proposal under the time period and procedures of section 6 of the Act, if it appears that the application's form or substance fails to meet the requirements of this part. This termination notification will state the nature of the issues raised and the specific condition of designation that the applicant would violate, appears to violate, or the violation of which cannot be ascertained from the application. Within ten days of receipt of this termination notification, the applicant seeking designation may request that the Commission render a decision whether to designate the contract market or to institute a proceeding to deny the proposed application under procedures specified in section 6 of

the Act by notifying the Commission that the applicant views its submission as complete and final as submitted.

(d) Request for withdrawal of application for designation or vacation of designation.

An applicant to be designated, or a designated contract market, may withdraw its application or vacate its designation under section 7 of the Act by filing with the Secretary of the Commission at its Washington, D.C., headquarters such a request. Withdrawal of an application for designation or vacation of designation 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 application for designation was pending with, or that the facility was designated by, the Commission.

(e) Delegation of authority. (1) The Commission hereby delegates, until it orders otherwise, to the Director of the Division of Division of Trading and Markets and separately to the Director of Economic Analysis or such other employee or employees as the Directors may designate from time to time, with the concurrence of the General Counsel or the General Counsel's delegatee, authority to notify the entity seeking designation under paragraph (a) of this section that review under those procedures is being terminated or to designate the entity as a contract market upon conditions.

(2) The Directors may submit to the Commission for its consideration any matter that has been delegated in this paragraph.

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

#### **§38.4 Procedures for listing products and implementing contract market rules.**

(a) Request for Commission approval of rules and products. (1) An applicant for designation, or a designated contract market, may request that the Commission approve under section 5c(c) of the Act, 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, prior to their implementation or, notwithstanding the provisions of section 5c(c)(2) of the Act, at anytime thereafter, under the procedures of §§40.5 or 40.3 of this chapter, as applicable. A designated contract market may label a product in its rules as, “Listed for trading pursuant to Commission approval,” if the product and its terms or conditions have been approved by the Commission and it may label as, “Approved by the Commission,” only those rules that have been so approved.

(2) Notwithstanding the forty-five day review period for voluntary approval under §§40.3(b) and 40.5(b) of this chapter, the operating rules and the terms and conditions of products submitted for voluntary Commission approval under §§40.3 or 40.5 of this chapter that have been submitted at the same time as, or while an application for contract market designation is pending, will be deemed approved by the Commission no earlier than the facility is deemed to be designated.

(b) Self-certification of rules and products. Rules of a designated contract market and subsequent amendments thereto, including both operational rules and the terms or conditions of products listed for trading on the facility, not voluntarily submitted for prior Commission approval pursuant to paragraph (a) of this section must be submitted to the Commission with a certification that the rule, rule amendment or product complies with the Act or rules thereunder

pursuant to the procedures of §§40.6 and 40.2 of this chapter, as applicable. Provided, however, any rule or rule amendment that would, for a delivery month having open interest, materially change a term or condition of a contract for future delivery in an agricultural commodity enumerated in section 1a(4) of the Act, or of an option on such a contract or commodity, must be submitted to the Commission prior to its implementation for review and approval under §40.4 of this chapter.

(c) An applicant for designation, or a designated contract market, may request that the Commission consider under the provisions of section 15(b) of the Act any of the contract market's rules or policies, including both operational rules and the terms or conditions of products listed for trading.

### **§38.5 Information relating to contract market compliance.**

(a) Upon request by the Commission, a designated contract market shall file with the Commission such information related to its business as a contract market, 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 request.

(b) Upon request by the Commission, a designated contract market shall file with the Commission a written demonstration, containing such supporting data, information and documents, in the form and manner and within such time as the Commission may specify, that the designated contract market is in compliance with one or more core principles as specified in the request.

### **§38.6 Enforceability.**

An agreement, contract or transaction entered into on or pursuant to the rules of a designated contract market shall not be void, voidable, subject to rescission or otherwise invalidated or rendered unenforceable as a result of:

(a) A violation by the designated contract market of the provisions of section 5 of the Act or this part 38; or

(b) Any Commission proceeding 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 alter, supplement, or require a designated contract market to adopt a specific term or condition, trading rule or procedure, or to take or refrain from taking a specific action.

### **Appendix A to Part 38--Application Guidance**

This appendix provides guidance for applicants for designation as a contract market under sections 5(b) and 6 of the Act and § 38.3, on meeting the criteria for designation both initially and on an ongoing basis. The guidance following each designation criterion is illustrative only of the types of matters an applicant may address, as applicable, and is not intended to be a mandatory checklist. Addressing the issues and questions set forth in this appendix would help the Commission in its consideration of whether the application has met the criteria for designation. To the extent that compliance with, or satisfaction of, a criterion for designation is not self-explanatory from the face of the contract market's rules, which may be trading protocols or terms and conditions, the application should include an explanation or other

form of documentation demonstrating that the applicant meets the designation criteria of section 5(b) of the Act.

Designation Criterion 1 of section 5(b) of the Act: IN GENERAL--To be designated as a contract market, the board of trade shall demonstrate to the Commission that the board of trade meets the criteria specified in this subsection.

A board of trade preparing to submit to the Commission an application for designation as a contract market is encouraged to contact Commission staff for guidance and assistance in preparing an application. Applicants may submit a draft application for review and feedback prior to the submission of an actual application without triggering the application review procedures of § 38.3.

Designation Criterion 2 of section 5(b) of the Act: PREVENTION OF MARKET MANIPULATION--The board of trade shall have the capacity to prevent market manipulation through market surveillance, compliance, and enforcement practices and procedures, including methods for conducting real-time monitoring of trading and comprehensive and accurate trade reconstructions.

A designation application should demonstrate a capacity to prevent market manipulation, including that the contract market has trading and participation rules deterring abuses and a dedicated regulatory department, or an effective delegation of that function.

Designation Criterion 3 of section 5(b) of the Act: FAIR AND EQUITABLE TRADING--The board of trade shall establish and enforce trading rules to ensure fair and equitable trading through the facilities of the contract market, and the capacity to detect, investigate, and discipline any person that violates the rules. The rules may authorize--(A) transfer trades or office trades; (B) an exchange of--(i) futures in connection with a cash commodity transaction; (ii) futures for cash commodities; or (iii) futures for swaps; or (C) a futures commission merchant, acting as principal or agent, to enter into or confirm the execution of a contract for the purchase or sale of

a commodity for future delivery if the contract is reported, recorded, or cleared in accordance with the rules of the contract market or a derivatives clearing organization.

(a) Establishing and enforcing trading rules to ensure fair and equitable trading on a contract market, among other things, includes providing to market participants, on a fair, equitable and timely basis, information regarding, prices, bids and offers, as applicable to the market.

(b) Such trading rules should be designed with adequate specificity.

(c) A contract market that authorizes transfer trades or office trades; an exchange of futures for physicals or futures for swaps; or any other non-competitive transactions, including block trades, should have rules particularly authorizing such transactions and establishing appropriate recordkeeping requirements.

Designation Criterion 4 of section 5(b) of the Act: TRADE EXECUTION FACILITY--The board of trade shall--(A) establish and enforce rules defining, or specifications detailing, the manner of operation of the trade execution facility maintained by the board of trade, including rules or specifications describing the operation of any electronic matching platform; and (B) demonstrate that the trade execution facility operates in accordance with the rules or specifications.

(a) An application of a board of trade to be designated as a contract market should include the system's trade-matching algorithm and order entry procedures. An application involving a trade-matching algorithm that is based on order priority factors other than price and time should include a brief explanation of the algorithm.

(b) A designated contract market's specifications on initial and periodic objective testing and review of proper system functioning, adequate capacity and security for any automated systems should be included in its application. A board of trade should submit in the contract market application, information on the objective testing and review carried out on its automated system. 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"), and adopted by the Commission on November 21, 1990 (55 FR 48670), as supplemented in October, 2000, are appropriate guidelines for an electronic trading facility to apply to electronic trading systems. Any program of objective testing and review of the system should be performed by a qualified independent professional (but not necessarily a third-party contractor).

Designation Criterion 5 of section 5(b) of the Act: FINANCIAL INTEGRITY OF TRANSACTIONS--The board of trade shall establish and enforce rules and procedures for ensuring the financial integrity of transactions entered into by or through the facilities of the contract market, including the clearance and settlement of the transactions with a derivatives clearing organization.

(a) A designated contract market should provide for the financial integrity of transactions by setting appropriate minimum financial standards for members and non-intermediated market participants, margining systems, appropriate margin forms and appropriate default rules and procedures. Absent Commission action pursuant to its exemptive authority under section 4(c) of the Act, transactions executed on the contract market (other than stock futures products), if cleared, must be cleared through a derivatives clearing organization registered as such with the Commission. The Commission believes ensuring and enforcing the financial integrity of transactions and intermediaries, and the protection of customer funds should include monitoring

compliance with the contract market's minimum financial standards. In order to monitor for minimum financial requirements, a contract market should routinely receive and promptly review financial and related information.

(b) A designated contract market should have rules concerning the protection of customer funds that address appropriate minimum financial standards for intermediaries, the segregation of customer and proprietary funds, the custody of customer funds, the investment standards for customer funds, related recordkeeping procedures and related intermediary default procedures.

Designation Criterion 6 of section 5(b) of the Act: DISCIPLINARY PROCEDURES--The board of trade shall establish and enforce disciplinary procedures that authorize the board of trade to discipline, suspend, or expel members or market participants that violate the rules of the board of trade, or similar methods for performing the same functions, including delegation of the functions to third parties.

The disciplinary procedures established by a designated contract market should give the contract market both the authority and ability to discipline and limit or suspend a member's activities as well as the authority and ability to terminate a member's activities pursuant to clear and fair standards. The authority to discipline or limit or suspend the activities of a member or of a market participant could be established in a contract market's rules, user agreements or other means. An organized exchange or a trading facility could satisfy this criterion for a member with trading privileges but having no, or only nominal, equity in the facility and for a non-member market participant by expelling or denying future access to such persons upon a finding that such a person has violated the board of trade's rules.

Designation Criterion 7 of section 5(b) of the Act: PUBLIC ACCESS--The board of trade shall provide the public with access to the rules, regulations, and contract specifications of the board of trade.

A board of trade operating as a contract market may provide information to the public by placing the information on its web site.

Designation Criterion 8 of section 5(b) of the Act: ABILITY TO OBTAIN INFORMATION--The board of trade shall establish and enforce rules that will allow the board of trade to obtain any necessary information to perform any of the functions described in this subsection, including the capacity to carry out such international information-sharing agreements as the Commission may require.

A designated contract market should have the authority to collect information and documents on both a routine and non-routine basis including the examination of books and records kept by the contract market's members and by non-intermediated market participants. Appropriate information-sharing agreements could be established with other boards of trade or the Commission could act in conjunction with the contract market to carry out such information sharing.

### **Appendix B to Part 38--Guidance on, and Acceptable Practices in, Compliance with Core Principles**

1. This appendix provides guidance concerning the core principles with which a board of trade must comply to maintain designation under section 5(d) of the Act and §§ 38.3 and 38.5. The guidance is provided in subsection (a) following each core principle and it can be used to demonstrate to the Commission core principle compliance, under §§ 38.3(a) and 38.5. The

guidance for each core principle is illustrative only of the types of matters a board of trade may address, as applicable, and is not intended to be a mandatory checklist. Addressing the issues and questions set forth in this appendix would help the Commission in its consideration of whether the board of trade is in compliance with the core principles. To the extent that compliance with, or satisfaction of, a core principle is not self-explanatory from the face of the board of trade's rules, which may be terms and conditions or trading protocols, an application pursuant to § 38.3, or a submission pursuant to § 38.5 should include an explanation or other form of documentation demonstrating that the board of trade complies with the core principles.

2. Acceptable practices meeting the requirements of the core principles are set forth in subsection (b) following each core principle. Boards of trade that follow the specific practices outlined under subsection (b) for any core principle in this appendix will meet the applicable core principle. Subsection (b) is for illustrative purposes only, and does not state the exclusive means for satisfying a core principle.

Core Principle 1 of section 5(d) of the Act: IN GENERAL--To maintain the designation of a board of trade as a contract market, the board of trade shall comply with the core principles specified in this subsection. The board of trade shall have reasonable discretion in establishing the manner in which it complies with the core principles.

A board of trade applying for designation as a contract market must satisfactorily demonstrate its capacity to operate in compliance with the core principles under section 5(d) of the Act and § 38.3. The Commission may require that a board of trade operating as a contract market demonstrate to the Commission that it is in compliance with one or more core principles.

Core Principle 2 of section 5(d) of the Act: COMPLIANCE WITH RULES--The board of trade shall monitor and enforce compliance with the rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.

(a) Application Guidance. (1) A designated contract market 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 the contract market's members and by non-intermediated market participants. The arrangements and resources should facilitate the direct supervision of the market and the analysis of data collected. Trade practice surveillance programs could be carried out by the contract market itself or through delegation to a third party. If the contract market delegates the responsibility of carrying out a trade practice surveillance program to a third party, such third party should have the capacity and authority to carry out such program, and the contract market should retain appropriate supervisory authority over the third party.

(2) A designated contract market 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 the activities of a member or market participant as well as the authority and ability to terminate the activities of a member or market participant pursuant to clear and fair standards. An organized exchange or a trading facility could satisfy this criterion for members with trading privileges but having no, or only nominal, equity in the facility and non-member market participants, by expelling or denying such persons future access upon a determination that such a person has violated the board of trade's rules.

(b) Acceptable Practices. An acceptable trade practice surveillance program generally would include:

(1) Maintenance of data reflecting the details of each transaction executed on the contract market;

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

(3) Appropriate and thorough investigative analysis of these and other potential trading violations brought to the contract market's 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 the activities of a member or market participant pursuant to clear and fair standards that are available to market participants. See, e.g. 17 CFR Part 8.

Core Principle 3 of section 5(d) of the Act: CONTRACTS NOT READILY SUBJECT TO MANIPULATION--The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation.

(a) Application Guidance. Contract markets may list new products for trading by self-certification under § 40.2 of this chapter or may submit products for Commission approval under § 40.3 and part 40, Appendix A, of this chapter.

(b) Acceptable Practices. Guideline No. 1, 17 CFR Part 40, Appendix A may be used as guidance in meeting this core principle for both new product listings and existing listed contracts.

Core Principle 4 of section 5(d) of the Act: MONITORING OF TRADING--The board of trade shall monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.

(a) Application Guidance. A contract market could prevent market manipulation through a dedicated regulatory department, or by delegation of that function to an appropriate third party.

(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 designated contract market 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 (1) to the size and ownership of deliverable supplies--the existing supply and the future or potential supply, and (2) to the pricing of the deliverable commodity relative to the futures price and relative to similar, but nondeliverable, kinds of the commodity. For cash-settled markets, it is more appropriate to pay attention to the availability and pricing of the commodity making up the index to which the market will be settled, as well as monitoring the continued suitability of the methodology for deriving the index.

(3) To assess traders' activity and potential power in a market, at a minimum, every contract market should have routine access to the positions and trading of its market participants and, if applicable, should provide for such access through its agreements with its third-party provider of clearing services. Although clearing member data may be sufficient for some contract markets, an effective surveillance program for contract markets with substantial numbers of customers trading through intermediaries should employ a much more comprehensive large-trader reporting system (LTRS).

Core Principle 5 of section 5(d) of the Act: POSITION LIMITATIONS OR ACCOUNTABILITY--To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary and appropriate.

(a) Application Guidance. [Reserved]

(b) Acceptable Practices.

(1) In order to diminish potential problems arising from excessively large speculative positions, and to facilitate orderly liquidation of expiring futures contracts, markets may need to set limits on traders' positions for certain commodities. These position limits specifically may exempt bona fide hedging, permit other exemptions, or set limits differently by markets, by delivery months, or by time periods. For purposes of evaluating a contract market's 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) Provisions concerning speculative position limits are set forth in part 150. In general, position limits are not necessary for markets where the threat of excessive speculation or manipulation is nonexistent or very low. Thus, contract markets do not need to adopt speculative position limits for futures markets on major foreign currencies, contracts based on certain financial instruments having very liquid and deep underlying cash markets, and contracts specifying cash settlement where the potential for distortion of such price is negligible. Where speculative position limits are necessary, acceptable speculative-limit levels typically should be set in terms of a trader's combined position in the futures contract plus its position in the related option contract (on a delta-adjusted basis).

(3) A contract market 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.

(4) Spot-month limits should be adopted for markets based on commodities having more limited deliverable supplies or where otherwise necessary to minimize the susceptibility of the market to manipulation or price distortions. The level of the spot limit 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.

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

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

(7) Contract markets should establish a program for effective enforcement of these limits. Contract markets should use their LTRS to monitor and enforce daily compliance with position limit rules. The Commission notes that a contract market may allow traders to periodically apply to the contract market for an exemption and, if appropriate, be granted a position level higher than the applicable speculative limit. The contract market should establish a program to monitor approved exemptions from the limits. The position levels granted under such hedge exemptions generally are based upon the trader's commercial activity in related markets. Contract markets

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. A contract market 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 contract market approve a specific maximum higher level.

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

(9) A violation of contract market position limits that have been approved by the Commission is also a violation of section 4a(e) of the Act. The Commission will consider for approval all contract market position limit rules.

Core Principle 6 of section 5(d) of the Act: EMERGENCY AUTHORITY--The board of trade shall adopt rules to provide for the exercise of emergency authority, in consultation or cooperation with the Commission, where necessary and appropriate, including the authority to-- (A) liquidate or transfer open positions in any contract; (B) suspend or curtail trading in any contract; and (C) require market participants in any contract to meet special margin requirements.

(a) Application Guidance. A designated contract market should have clear procedures and guidelines for contract market decision-making regarding emergency intervention in the market, including procedures and guidelines to avoid conflicts of interest while carrying out

such decision-making. A contract market 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. Procedures and guidelines should also include notifying the Commission of the exercise of a contract market's regulatory emergency authority, minimizing conflicts of interest, and documenting the contract market's decision-making process and the reasons for using its emergency action authority. Information on steps taken under such procedures should be included in a submission of a certified rule under § 40.6 of this chapter and any related submissions for rule approval pursuant to § 40.5 of this chapter, when carried out pursuant to a contract market's emergency authority.

(b) Acceptable Practices. As is necessary to address perceived market threats, the contract market, 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 a 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 including non-intermediated market participants of the contract market to another, or alter the delivery terms or conditions, or, if applicable, should provide for such actions through its agreements with its third-party provider of clearing services.

Core Principle 7 of section 5(d) of the Act: AVAILABILITY OF GENERAL INFORMATION--The board of trade shall make available to market authorities, market participants, and the public information concerning--(A) the terms and conditions of the contracts of the contract market; and (B) the mechanisms for executing transactions on or through the facilities of the contract market.

(a) Application Guidance. A designated contract market should have arrangements and resources for the disclosure of contract terms and conditions and trading mechanisms to the Commission, market participants and the public. Procedures should also include providing information on listing new products, rule amendments or other changes to previously disclosed information to the Commission, market participants and the public. Provision of all such information to market participants and the public could be by timely placement of the information on a contract market's web site.

(b) Acceptable Practices. [Reserved]

Core Principle 8 of section 5(d) of the Act: DAILY PUBLICATION OF TRADING INFORMATION--The board of trade shall make public daily information on settlement prices, volume, open interest, and opening and closing ranges for actively traded contracts on the contract market.

(a) Application Guidance. A contract market should provide to the public information regarding settlement prices, price range, volume, open interest and other related market information for all actively traded contracts, as determined by the Commission, on a fair, equitable and timely basis. The Commission believes that section 5(d)(8) requires contract markets to publicize trading information for any non-dormant contract. Provision of information for any applicable contract could be through such means as provision of the information to a financial information service and by timely placement of the information on a contract market's web site.

(b) Acceptable Practices. [Reserved]

Core Principle 9 of section 5(d) of the Act: EXECUTION OF TRANSACTIONS--The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions.

(a) Application Guidance. (1) A competitive, open and efficient market and mechanism for executing transactions includes a board of trade's methodology for entering orders and executing transactions.f its providing .

(2) Appropriate objective testing and review of any automated systems should occur initially and periodically to ensure proper system functioning, adequate capacity and security. A designated contract market'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"), and adopted by the Commission on November 21, 1990 (55 FR 48670), as supplemented in October 2000, are appropriate guidelines for a designated contract market to apply to electronic trading systems. Any program of objective testing and review of the system should be performed by a qualified independent professional. The Commission believes that information gathered by analysis, oversight or any program of objective testing and review of any automated systems regarding system functioning, capacity and security should be made available to the Commission.

(3) A designated contract market that determines to allow block trading should ensure that the block trading does not operate in a manner that compromises the integrity of prices or price discovery on the relevant market.

(b) Acceptable Practices. A professional that is a certified member of the Information Systems Audit and Control Association experienced in the industry would be an example of an acceptable party to carry out testing and review of an electronic trading system.

Core Principle 10 of section 5(d) of the Act: TRADE INFORMATION--The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables the contract market to use the information for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market.

(a) Application Guidance. A designated contract market should have arrangements and resources for recording of full data entry and trade details and the safe storage of audit trail data. A designated contract market should have systems sufficient to enable the contract market to use the information for purposes of assisting in the prevention of customer and market abuses through reconstruction of trading.

(b) Acceptable Practices. (1) The goal of an audit trail is to detect and deter customer and market abuse. An effective contract market audit trail should capture and retain sufficient trade-related information to permit contract market staff to detect trading abuses and to reconstruct all transactions within a reasonable period of time. 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 or other disposition. The contract market must create and maintain an electronic transaction history database that contains information with respect to transactions executed on the designated contract market.

(2) An acceptable audit trail should include the following: original source documents, transaction history, electronic analysis capability, and safe storage capability. A contract market whose audit trail satisfies the following acceptable practices would satisfy Core Principle 10.

(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 (whether filled, unfilled or cancelled, each of which should be retained or electronically captured), 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 contract markets, 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) the categories of participants for which such trades are executed, including whether the person executing a trade was executing it for his/her own account or an account for which he/she has discretion, his/her clearing member's house account, the account of another member, including market participants present on the floor, or the account of any other customer; (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 17.

Core Principle 11 of section 5(d) of the Act: FINANCIAL INTEGRITY OF CONTRACTS--The board of trade shall establish and enforce rules providing for the financial integrity of any contracts traded on the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization), and rules to ensure the financial integrity of any futures commission merchants and introducing brokers and the protection of customer funds.

(a) Application Guidance. Clearing of transactions executed on a designated contract market other than transactions in security futures products, should be provided through a Commission-registered derivatives clearing organization. In addition, a designated contract market should maintain the financial integrity of its transactions by maintaining minimum financial standards for its members and non-intermediated market participants and by 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 designated contract market should routinely receive and promptly review financial and related information from its members. Rules concerning the protection of customer funds should address the segregation of customer and proprietary funds, the custody of customer funds, the investment standards for customer funds, related recordkeeping and related intermediary default procedures. The contract market should audit its members that are intermediaries for compliance with the foregoing rules as well as applicable Commission rules. These audits should be conducted consistent with the guidance set forth in Division of Trading and Markets Interpretations 4-1 and 4-2. A contract market may delegate to a designated self-

regulatory organization responsibility for receiving financial reports and for conducting compliance audits pursuant to the guidelines set forth in rule 1.52.

(b) Acceptable Practices. [Reserved]

Core Principle 12 of section 5(d) of the Act: PROTECTION OF MARKET PARTICIPANTS--The board of trade shall establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants.

(a) Application Guidance. A designated contract market 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. The contract market should have methods and resources appropriate to the nature of the trading system and the structure of the market to detect trade practice abuses.

(b) Acceptable Practices. [Reserved]

Core Principle 13 of section 5(d) of the Act: DISPUTE RESOLUTION--The board of trade shall establish and enforce rules regarding and provide facilities for alternative dispute resolution as appropriate for market participants and any market intermediaries.

(a) Application Guidance. A designated contract market should provide customer dispute resolution procedures that are fair and equitable and make them available on a voluntary basis, either directly or through another self-regulatory organization, to customers that are non-eligible contract participants..

(b) Acceptable Practices. (1) Under Core Principle 13, a designated contract market is required to provide for dispute resolution mechanisms that are appropriate to the nature of the market.

(2) In order to satisfy acceptable standards, a designated contract market should provide a customer dispute resolution mechanism that is fundamentally fair and is equitable. An acceptable customer dispute resolution mechanism would:

(i) Provide the customer with an opportunity to have his or her claim decided by an objective and impartial decision-maker,

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

(iii) Provide each party with adequate notice of the 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) Authorize prompt, written, final settlement awards that are not subject to appeal within the contract market, and

(v) Notify the parties of the fees and costs that may be assessed.

(3) The use of such procedures should be voluntary for customers who are not eligible contract participants, and could permit counterclaims as provided in § 166.5 of this chapter.

(4) If the designated contract market also provides a procedure for the resolution of disputes that do not involve customers (i.e., member-to-member disputes), the procedure for resolving such disputes must be independent of and shall not interfere with or delay the resolution of customers' claims or grievances.

(5) A designated contract market 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 designated contract market does delegate that responsibility, the contract market 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 14 of section 5(d) of the Act: GOVERNANCE FITNESS STANDARDS--The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, and any other persons with direct access to the facility (including any parties affiliated with any of the persons described in this paragraph).

(a) Application Guidance. (1) A designated contract market should have appropriate eligibility criteria for the categories of persons set forth in the Core Principle that should include standards for fitness and for the collection and verification of information supporting compliance with such standards. Minimum standards of fitness for persons who have member voting privileges, governing obligations or responsibilities, or who exercise disciplinary authority are those bases for refusal to register a person under section 8a(2) of the Act. In addition, persons who have governing obligations or responsibilities, or who exercise disciplinary authority, should not have a significant history of serious disciplinary offenses, such as those that would be disqualifying under § 1.63 of this chapter. Members with trading privileges but having no, or only nominal, equity in the facility and non-member market participants who are not intermediated and do not have these privileges, obligations, responsibilities or disciplinary authority could satisfy minimum fitness standards by meeting the standards that they must meet to qualify as a “market participant.” Natural persons who directly or indirectly have greater than

a ten percent ownership interest in a designated contract market should meet the fitness standards applicable to members with voting rights.

(2) The Commission believes that such standards should include providing the Commission with fitness information for such persons, whether registration information, certification to the fitness of such persons, an affidavit of such persons' fitness by the contract market's counsel or other information substantiating the fitness of such persons. If a contract market provides 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 his or her position.

(b) Acceptable Practices. [Reserved]

Core Principle 15 of section 5(d) of the Act: CONFLICTS OF INTEREST--The board of trade shall establish and enforce rules to minimize conflicts of interest in the decision making process of the contract market and establish a process for resolving such conflicts of interest.

(a) Application Guidance. The means to address conflicts of interest in decision-making of a contract market should include methods to ascertain the presence of conflicts of interest and to make decisions in the event of such a conflict. In addition, the Commission believes that the contract market should provide for appropriate limitations on the use or disclosure of material non-public information gained through the performance of official duties by board members, committee members and contract market employees or gained through an ownership interest in the contract market.

(b) Acceptable Practices. [Reserved]

Core Principle 16 of section 5(d) of the Act: COMPOSITION OF BOARDS OF MUTUALLY OWNED CONTRACT MARKETS--In the case of a mutually owned contract market, the board of trade shall ensure that the composition of the governing board reflects market participants.

(a) Application Guidance. The composition of a mutually-owned contract market should fairly represent the diversity of interests of the contract market's market participants.

(b) Acceptable Practices. [Reserved]

Core Principle 17 of section 5(d) of the Act: RECORDKEEPING--The board of trade shall maintain records of all activities related to the business of the contract market in a form and manner acceptable to the Commission for a period of 5 years.

(a) Application Guidance. [Reserved]

(b) Acceptable Practices. Section 1.31 of this chapter governs recordkeeping obligations under the Act and the Commission's regulations thereunder. In order to provide broad flexible performance standards for recordkeeping, § 1.31 was updated and amended by the Commission in 1999. Accordingly, § 1.31 itself establishes the guidance regarding the form and manner for keeping records.

Core Principle 18 of section 5(d) of the Act: ANTITRUST CONSIDERATIONS--Unless necessary or appropriate to achieve the purposes of this Act, the board of trade shall endeavor to avoid--(A) adopting any rules or taking any actions that result in any unreasonable restraints of trade; or (B) imposing any material anticompetitive burden on trading on the contract market.

(a) Application Guidance. An entity seeking designation as a contract market may request that the Commission consider under the provisions of section 15(b) of the Act any of the entity's rules, including trading protocols or policies, and including both operational rules and the terms or conditions of products listed for trading, at the time of designation or thereafter. The

Commission intends to apply section 15(b) of the Act to its consideration of issues under this core principle in a manner consistent with that previously applied to contract markets.

(b) Acceptable Practices. [Reserved]

11. Chapter I of 17 CFR is amended by adding new Part 40 as follows:

**PART 40--PROVISIONS COMMON TO CONTRACT MARKETS, DERIVATIVES  
TRANSACTION EXECUTION FACILITIES AND DERIVATIVES  
CLEARING ORGANIZATIONS**

Sec.

40.1 Definitions.

40.2 Listing products for trading by certification.

40.3 Voluntary submission of new products for Commission review and approval.

40.4 Amendments to terms or conditions of enumerated agricultural contracts.

40.5 Voluntary submission of rules for Commission review and approval.

40.6 Self-certification of rules by designated contract markets and registered derivatives clearing organizations.

40.7 Delegations.

Appendix A to Part 40--Guideline No. 1.

Appendix B--Schedule of fees.

Appendix C--Information that a foreign board of trade should submit when seeking no-action relief to offer and sell, to persons located in the United States, a futures contract on a foreign securities index traded on that foreign board of trade.

**Authority:** 7 U.S.C. 1a, 2, 5, 6, 6c, 7, 7a, 8 and 12a, as amended by the Commodity Futures Modernization Act of 2000, Appendix E of Pub. L. No. 106-554, 114 Stat. 2763 (2000).

#### **§40.1 Definitions.**

As used in this part:

Dormant contract means any commodity futures or option contract or other instrument in which no trading has occurred in any future or option expiration for a period of six complete calendar months; provided, however, no contract or instrument shall be considered to be dormant until the end of sixty complete calendar months following initial listing.

Emergency means any occurrence or circumstance which, in the opinion of the governing board of the contract market or derivatives transaction execution facility, requires immediate action and threatens or may threaten such things as the fair and orderly trading in, or the liquidation of or delivery pursuant to, any agreements, contracts or transactions on such a trading facility, including any manipulative or attempted manipulative activity; any actual, attempted, or threatened corner, squeeze, congestion, or undue concentration of positions; any circumstances which may materially affect the performance of agreements, contracts or transactions traded on the trading facility, including failure of the payment system or the bankruptcy or insolvency of any participant; any action taken by any governmental body, or any other board of trade, market or facility which may have a direct impact on trading on the trading facility; and any other

circumstance which may have a severe, adverse effect upon the functioning of a designated contract market or derivatives transaction execution facility.

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

Terms and conditions mean any definition of the trading unit or the specific commodity underlying a contract for the future delivery of a commodity or commodity option contract, specification of settlement or delivery standards and procedures, and establishment of buyers' and sellers' rights and obligations under the contract. Terms and conditions include provisions relating to the following:

- (1) Quality or quantity standards for a commodity and any applicable premiums or discounts;
- (2) Trading hours, trading months and the listing of contracts;
- (3) Minimum and maximum price limits and the establishment of settlement prices;
- (4) Position limits and position reporting requirements;
- (5) Delivery points and locational price differentials;

(6) Delivery standards and procedures, including alternatives to delivery and applicable penalties or sanctions for failure to perform;

(7) Settlement of the contract; and

(8) Payment or collection of commodity option premiums or margins.

#### **§40.2 Listing products for trading by certification.**

To list a new product for trading, to list a product for trading that has become dormant, or to accept for clearing a product (not traded on a designated contract market or a registered derivatives transaction execution facility), a registered entity must file with the Secretary of the Commission at its Washington, D.C., headquarters no later than the close of business of the business day preceding the product's listing or acceptance for clearing, either in electronic or hard-copy form, a copy of the product's rules, including its terms and conditions, or the rules establishing the terms and conditions of products that make them acceptable for clearing, and a certification by the registered entity that the trading product or other instrument, or the clearing of the trading product or other instrument including any rules establishing the terms and conditions of products that make them acceptable for clearing), complies with the Act and rules thereunder.

#### **§40.3 Voluntary submission of new products for Commission review and approval.**

(a) Request for approval. A designated contract market or registered derivatives transaction execution facility may request under section 5c(c)(2) of the Act that the Commission approve new products under the following procedures:

(1) The submitting entity labels the request as “Request for Commission Product Approval;”

(2) The request for product approval is for a commodity other than a security future or a security futures product as defined in sections 1a(31) or 1a(32) of the Act, respectively;

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

(4) The submission includes the fee required under Appendix B to this part.

(b) Forty-five day review. All products submitted for Commission approval under this paragraph shall be deemed approved by the Commission forty-five days after receipt by the Commission, or at the conclusion of such extended period as provided under paragraph (c) of this section, unless notified otherwise within the applicable period, if:

(1) The submission complies with the requirements of paragraph (a) of this section; and

(2) The submitting entity does not amend the terms or conditions of the product or supplement the request for approval, except as requested by the Commission or for correction of typographical errors, renumbering or other such nonsubstantive revisions, during that period.

Any voluntary, substantive amendment by the submitting entity will be treated as a new submission under this section.

(c) Extension of time. The Commission may extend the forty-five day review period in paragraph (b) of this section for:

(1) An additional forty-five days, if within the initial forty-five day review period, the Commission notifies the submitting entity that the product raises novel or complex issues that 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; or

(2) Such period as the submitting entity so instructs the Commission in writing.

(d) Notice of non-approval. The Commission at any time during its review under this section may notify the submitting entity that it will not, or is unable to, approve the product or instrument. This notification will briefly specify the nature of the issues raised and the specific provision of the Act or regulations, including the form or content requirements of paragraph (a) of this section, that the product would violate, appears to violate or the violation of which cannot be ascertained from the submission.

(e) Effect of non-approval. (1) Notification to a submitting entity under paragraph (d) of this section of the Commission's refusal to approve a product or instrument does not prejudice the entity from subsequently submitting a revised version of the product or instrument for Commission approval or from submitting the product or instrument as initially proposed pursuant to a supplemented submission.

(2) Notification to a submitting entity under paragraph (d) of this section of the Commission's refusal to approve a product shall be presumptive evidence that the entity may not truthfully certify under §40.2 that the same, or substantially the same, product does not violate the Act or rules thereunder.

#### **§40.4 Amendments to terms or conditions of enumerated agricultural contracts.**

(a) Designated contract markets must submit for Commission approval under the procedures of §40.5, prior to its implementation, any rule or rule amendment that, for a delivery month having open interest, would materially change a term or condition as defined in §40.1(f), of a contract for future delivery in an agricultural commodity enumerated in section 1a(4) of the Act, or of an option on such a contract or commodity.

(b) The following rules or rule amendments are not material changes:

(1) Changes in trading hours;

(2) Changes in lists of approved delivery facilities pursuant to previously set standards or criteria;

(3) Changes to terms and conditions of options on futures other than those relating to last trading day, expiration date, option strike price delistings, and speculative position limits;

(4) Reductions in the minimum price fluctuation (or “tick”);

(5) Changes required to comply with a binding order of a court of competent jurisdiction, or a rule, regulation or order of the Commission or of another Federal regulatory authority; and

(6) Any other rule, the text of which has been submitted to the Secretary of the Commission at least ten days prior to its implementation at its Washington, D.C. headquarters and that has been labeled “Non-material Agricultural Rule Change,” and with respect to which

the Commission has not notified the contract market during that period that the rule appears to require or does require prior approval under this section.

**§40.5 Voluntary submission of rules for Commission review and approval.**

(a) Request for approval of rules. A registered entity may request pursuant to section 5c(c) of the Act that the Commission approve any rule or proposed rule or rule amendment under the following procedures:

(1) Three copies of each rule or rule amendment submission under this section shall be furnished in hard copy form to the Secretary of the Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street NW., Washington, DC 20581 or electronically in a format specified by the Secretary of the Commission. One copy of each submission shall be transmitted by the registered entity to the regional office of the Commission having local jurisdiction over the registered entity. Each request for approval under this section shall be in the following order and shall:

- (i) Label the submission as “Request for Commission rule approval;”
- (ii) Set forth the text of the rule or proposed rule (in the case of a rule amendment, deletions and additions must be indicated);
- (iii) 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 registered entity 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;

(iv) 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 registered entity'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;

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

(vi) 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 amendment or interpretation of the Commission's regulation.

(2) [Reserved]

(b) Forty-five day review. All rules submitted for Commission approval under paragraph (a) of this section shall be deemed approved by the Commission under section 5c(c) of the Act, forty-five days after receipt by the Commission, or at the conclusion of such extended period as provided under paragraph (c) of this section, unless notified otherwise within the applicable period, if:

(1) The submission complies with the requirements of paragraphs (a)(1)(i) through (vi) of this section, and

(2) 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. Any amendment or supplementation not requested by the Commission will be treated as the submission of a new filing under this section.

(c) Extensions of time. The Commission may extend the review period in paragraph (b) of this section for:

(1) An additional thirty days, if the Commission, within the initial forty-five day review period, notifies the submitting entity that the proposed rule raises novel or complex issues that 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; or

(2) Such additional period as the submitting entity has so instructed the Commission in writing.

(d) Notice of non-approval. The Commission at any time during its review under this section may notify the submitting entity that it will not, or is unable to, approve the proposed rule or rule amendment. This notification will briefly specify the nature of the issues raised and the specific provision of the Act or regulations, including the form or content requirements of this section, that the proposed rule would violate, appears to violate or the violation of which cannot be ascertained from the submission.

(e) Effect of non-approval. (1) Notification to a registered entity under paragraph (d) of this section of the Commission's refusal to approve a proposed rule or rule amendment of a registered entity does not prejudice the entity from subsequently submitting a revised version of the proposed rule or rule amendment for Commission approval or from submitting the rule or rule amendment as initially proposed pursuant to a supplemented submission.

(2) Notification to a registered entity under paragraph (d) of this section of the Commission's refusal to approve a proposed rule or rule amendment of a registered entity shall be presumptive evidence that the entity may not truthfully certify that the same, or substantially the same, proposed rule or rule amendment does not violate the Act or rules thereunder.

(f) Expedited approval. Notwithstanding the provisions of paragraph (b) of this section, changes to terms and conditions of a product that are consistent with the Act and Commission regulations and with standards approved or established by the Commission in a written notification to the registered entity of the applicability of this paragraph (f) shall be deemed approved by the Commission at such time and under such conditions as the Commission shall specify in the notice, provided, however, that the Commission may, at any time, alter or revoke the applicability of such a notice to any particular product.

**§40.6 Self-certification of rules by designated contract markets and registered derivatives clearing organizations.**

(a) Required certification. A designated contract market or a registered derivatives clearing organization may implement any new rule or rule amendment (other than a rule or rule amendment approved or deemed approved by the Commission under §40.5 of this chapter) only if:

(1) The rule or rule amendment is not a rule or rule amendment of a designated contract market that materially changes a term or condition of a contract for future delivery of an agricultural commodity enumerated in section 1a(4) of the Act or an option on such a contract or commodity in a delivery month having open interest;

(2) The designated contract market or registered derivatives clearing organization has filed a submission for the rule or rule amendment with the Commission at its Washington, D.C. headquarters and at the regional office having local jurisdiction, and the Commission has received the submission at its headquarters by close of business on the business day preceding implementation of the rule; provided, however, rules or rule amendments implemented under procedures of the governing board to respond to an emergency as defined in §40.1(d), shall, if practicable, be filed with the Commission prior to the implementation or, if not practicable, be filed with the Commission at the earliest possible time after implementation but in no event more than 24 hours after implementation; and

(3) The rule submission includes:

(i) The label, “Rule Certification” or, in the case of a rule or rule amendment that responds to an emergency, “Emergency Rule Certification;”

(ii) The text of the rule (in the case of a rule amendment, deletions and additions must be indicated);

(iii) The date of implementation;

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

(v) A certification by the entity that the rule complies with the Act and regulations thereunder.

(b) Stay. The Commission may stay the effectiveness of a rule implemented pursuant to paragraph (a) of this section during the pendency of Commission proceedings for filing a false certification or to alter or amend the rule pursuant to section 8a(7) of the Act. The decision to stay the effectiveness of a rule in such circumstances shall not be delegable to any employee of the Commission.

(c) Notification of rule amendments. Notwithstanding the rule certification requirement of section 5c(c)(1) of the Act, and paragraphs (a)(2) and (a)(3) of this section, a designated contract market or a registered derivatives clearing organization may place the following rules or rule amendments into effect without certification to the Commission if the following conditions are met:

(1) The designated contract market or registered derivatives 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 to the Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street N.W., Washington, DC 20581, or electronically in a format specified by the Secretary of the Commission; and

(2) The rule governs:

(i) Nonmaterial revisions. Corrections of typographical errors, renumbering, periodic routine updates to identifying information about approved entities and other such nonsubstantive revisions of a product's terms and conditions that have no effect on the economic characteristics of the product;

(ii) Delivery standards set by third parties. Changes to grades or standards of commodities deliverable on a product that are established by an independent third party and that are incorporated by reference as product terms, provided that the grade or standard is not established, selected or calculated solely for use in connection with futures or option trading and such changes do not affect deliverable supplies or the pricing basis for the product;

(iii) Index products. 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 product's terms, that do not affect the pricing basis of the index, which are 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 product; or

(iv) Option contract terms. Changes to option contract rules relating to the strike price listing procedures, strike price intervals, and the listing of strike prices on a discretionary basis.

(3) Notification of rule amendments not required. Notwithstanding the rule certification requirements of section 5c(c)(1) of the Act and of paragraphs (a)(2) and (a)(3) of this section, designated contract markets and registered derivatives clearing organizations may place the following rules or rule amendments into effect without certification or notice to the Commission if the following conditions are met:

(i) The designated contract market or registered derivatives clearing organization maintains documentation regarding all changes to rules; and

(ii) The rule governs:

(A) 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;

(B) 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, Board of Directors or Committee composition requirements, or procedures or requirements relating to conflicts of interest;

(C) 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; and

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

#### **§40.7 Delegations.**

(a) Procedural matters.

(1) Review of products or rules. The Commission hereby delegates, until it orders otherwise, to the Director of the Division of Trading and Markets and separately to the Director 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 §40.3(b)(2) or §40.5(b)(2) that the entity requesting approval amend the proposed product, rule or rule amendment or supplement the submission, to notify a submitting entity under §40.3(c) or §40.5(c) that the time for review has been extended, and to notify the submitting entity under §40.3(d) or §40.5(d) that the Commission is not approving, or is unable to approve, the proposed product, rule or rule amendment.

(2) Emergency rules. The Commission hereby delegates authority to the Director of the Division of Trading and Markets, or the delegates of the Director, authority to receive notification and the required certification of emergency rules under §40.6(a)(2).

(b) Approval authority. The Commission hereby delegates, until the Commission orders otherwise, to the Director of the Division of Trading and Markets and separately to the Director of Economic Analysis, with the concurrence of the General Counsel or the General Counsel's delegatee, to be exercised by either of such Directors or by such other employee or employees of the Commission under the supervision of such Directors as may be designated from time to time by the Directors, the authority to approve, pursuant to section 5c(c)(3) of the Act and §40.5, rules or rule amendments of a designated contract market, registered derivatives transaction execution facility or registered derivatives clearing organization that:

(1) Relate to, but do not materially change, the quantity, quality, or other delivery specifications, procedures, or obligations for delivery, cash settlement, or exercise under an

agreement, contract or transaction approved for trading by the Commission; daily settlement prices; clearing position limits; requirements or procedures for governance of a registered entity; procedures for transfer trades; trading hours; minimum price fluctuations; and maximum price limit and trading suspension provisions;

(2) Reflect routine modifications that are required or anticipated by the terms of the rule of a registered entity;

(3) [Reserved].

(4) Are in substance the same as a rule of the same or another registered entity which has been approved previously by the Commission pursuant to section 5c(c)(3) of the Act;

(5) Are consistent with a specific, stated policy or interpretation of the Commission;  
or

(6) Relate to the listing of additional trading months of approved contracts.

(c) The Directors may submit to the Commission for its consideration any matter that has been delegated pursuant to paragraph (a) or (b) of this section.

(d) Nothing in this section shall be deemed to prohibit the Commission, at its election, from exercising the authority delegated in paragraph (a) or (b) of this section to the Directors.

\* \* \* \* \*

## **Appendix B--Schedule of fees**

(a) Applications for product approval. Each application for product approval under §40.3 must be accompanied by a check or money order made payable to the Commodity Futures Trading Commission in an amount to be determined annually by the Commission and published in the Federal Register.

(b) Checks and applications should be sent to the attention of the Office of the Secretariat, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, DC 20581. No checks or money orders may be accepted by personnel other than those in the Office of the Secretariat.

(c) Failure to submit the fee with an application for product approval will result in return of the application. Fees will not be returned after receipt.

\* \* \* \* \*

12. Appendix A to Part 5 is redesignated as Appendix A to Part 40 and the heading is revised; Appendix E to Part 5 is redesignated as Appendix C to Part 40; and Part 5 is removed and reserved. The revised heading reads as follows:

### **Appendix A to Part 40--Guideline No. 1**

13. Chapter I of 17 CFR is amended by adding new Part 41 as follows:

#### **PART 41--SECURITY FUTURES**

Sec.

41.1 [Reserved]

## **PART 166--CUSTOMER PROTECTION RULES**

14. The authority citation for Part 166 is revised to read as follows:

**Authority:** 7 U.S.C. 1a, 2, 6b, 6c, 6d, 6g, 6h, 6k, 6l, 6o, 7, 12a, 21, and 23, as amended by the Commodity Futures Modernization Act of 2000, Appendix E of Pub. L. 106-554, 114 Stat. 2763 (2000).

15. Section 166.5 is added to read as follows:

### **§166.5 Dispute settlement procedures.**

(a) Definitions. (1) The term claim or grievance as used in this section shall mean any dispute that:

(i) Arises out of any transaction executed on or subject to the rules of a designated contract market,

(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 designated contract market, or a participant transacting on or through such designated contract market, effects a transaction on such contract market, except another member of or participant in such designated contract market. Provided, however, a person who is an “eligible contract participant” as defined in section 1a(12) of the Act shall not be deemed to be a customer within the meaning of this section.

(3) The term Commission registrant as used in this section means a person registered under the Act as a futures commission merchant, introducing broker, floor broker, commodity pool operator, commodity trading advisor, or associated person.

(b) Voluntariness. The use by customers of dispute settlement procedures shall be voluntary as provided in paragraphs (c) and (g) of this section.

(c) Customers. No Commission registrant shall enter into any agreement or understanding with a customer in which the customer agrees, prior to the time a claim or grievance arises, to submit such claim or grievance to any settlement procedure except as follows:

(1) Signing the agreement must not be made a condition for the customer to utilize the services offered by the Commission registrant.

(2) If the agreement is contained as a clause or clauses of a broader agreement, the customer must separately endorse the clause or clauses containing the cautionary language and provisions specified in this section. A futures commission merchant or introducing broker may

obtain such endorsement as provided in §1.55(d) of this chapter for the following classes of customers only:

(i) A plan defined as a government plan or church plan in section 3(32) or section 3(33) of title I of the Employee Retirement Income Security Act of 1974 or a foreign person performing a similar role or function subject as such to comparable foreign regulation; and

(ii) A person who is a "qualified eligible participant" or a "qualified eligible client" as defined in §4.7 of this chapter.

(3) The agreement may not require any customer to waive the right to seek reparations under section 14 of the Act and part 12 of this chapter. Accordingly, such customer must be advised in writing that he or she may seek reparations under section 14 of the Act by an election made within 45 days after the Commission registrant notifies the customer that arbitration will be demanded under the agreement. This notice must be given at the time when the Commission registrant notifies the customer of an intention to arbitrate. The customer must also be advised that if he or she seeks reparations under section 14 of the Act and the Commission declines to institute reparations 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 dispute resolution, together with a copy of the rules of each forum listed. The list must include:

(A) The designated contract market, 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 designated contract market or employee thereof, and that are not otherwise associated with the designated contract market (mixed panel):

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

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

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

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

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

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

**By signing this agreement, you: (1) May be waiving your right to sue in a court of law; and (2) are agreeing to be bound by arbitration of any claims or counterclaims which you or [name] may submit to arbitration under this agreement. You are not, however, waiving your right to elect instead to petition the CFTC to institute reparations**

**proceedings under Section 14 of the Commodity Exchange Act with respect to any dispute that may be arbitrated pursuant to this agreement. In the event a dispute arises, you will be notified if [name] intends to submit the dispute to arbitration. If you believe a violation of the Commodity Exchange Act is involved and if you prefer to request a section 14 ``Reparations'' proceeding before the CFTC, you will have 45 days from the date of such notice in which to make that election.**

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

(d) Enforceability. A dispute settlement procedure may require parties utilizing such procedure to agree, under applicable state law, submission agreement or otherwise, to be bound by an award rendered in the procedure, provided that the agreement to submit the claim or grievance to the procedure was made in accordance with paragraph (c) or (g) 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 designated contract market shall not include any unreasonably short limitation period foreclosing submission of customers' claims or grievances or counterclaims.

(f) Counterclaims. A procedure established by a designated contract market 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 designated contract market 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 designated contract market does not have jurisdiction. Other counterclaims arising out of a transaction subject to the Act and rules promulgated thereunder for which the customer utilizes the services of the registrant may be permissible where the customer and the registrant have agreed in advance to require that all such submissions be included in the proceeding, and if the aggregate monetary value of the counterclaims is capable of calculation.

(g) Eligible contract participants. A person who is an “eligible contract participant” as defined in section 1a(12) of the Act may negotiate any term of an agreement or understanding with a Commission registrant in which the eligible contract participant agrees, prior to the time a claim or grievance arises, to submit such claim or grievance to any settlement procedure provided for in the agreement.

## **PART 170--REGISTERED FUTURES ASSOCIATIONS**

Subpart A--Standards Governing Commission Review of Applications for Registration as a Futures Association Under Section 17 of the Act

16. The authority citation for Part 170 is revised to read as follows:

**Authority:** 7 U.S.C. 6p, 12a, and 21, as amended by the Commodity Futures Modernization Act of 2000, Appendix E of Pub. L. 106-554, 114 Stat. 2763 (2000).

17. Section 170.8 is revised to read as follows:

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

A futures association must be able to demonstrate its capacity to promulgate rules and to conduct proceedings that 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 §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**

18. Part 180 is removed.

Issued in Washington, D.C., this 30<sup>th</sup> day of July, 2001, by the Commission.

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Jean A. Webb,  
Secretary of the Commission.

**Dissent of Commissioner Thomas J. Erickson**  
**Rules Implementing the Commodity Futures Modernization Act (CFMA)**  
**With Respect to Transaction Execution Facilities**

I dissent from the publication of these final rules because they fall well short of the minimum standards necessary to maintain integrity of markets and protect customers from trade practice abuses. Today, the Commission promulgates final rules intended to implement the Commodity Futures Modernization Act of 2000.<sup>1</sup> While the Commission's rules reflect the thrust of the CFMA, they fail to recognize the discretion afforded the agency to ensure that the markets it oversees remain open, fair and transparent.

I am confident that the new regulatory regime will foster the competitiveness of U.S. derivatives marketplaces, and that is good. I am less confident that the regulations implementing this new regime will foster open and competitive bids and offers for transactions in markets, which for customers and commercial participants is bad. Thus, I have repeatedly requested comment on those issues that would enable this agency to be confident that its regulatory framework retains tools necessary to detect and deter manipulation, detect and deter abusive trade practices, and vigorously enforce our fraud authority.<sup>2</sup> Where this Commission has a regulatory interest, it should be demanding the maximum transparency allowed by law.<sup>3</sup> Today's rules, I fear, leave enormous gaps in our regulatory oversight regime.

The longstanding tradition of public, open markets in the United States seems to have given way to the notion that private, closed markets are superior in every respect. Perhaps private, closed markets are more expedient for their participants. But it will be incumbent on industry participants to see to it that the public interest in open, fair and transparent markets is not compromised.

In the end, public confidence in our markets will depend upon how the industry adapts to and carries out its new responsibilities under the law and these regulations. I sincerely hope that the derivatives markets will find self-interest to be a powerful motivator and that market participants will reward those markets adhering to the highest standards of market integrity.

/S/ \_\_\_\_\_  
Commissioner Thomas J. Erickson

7/26/01  
Date

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<sup>1</sup> See Commodity Futures Modernization Act of 2000, Appendix E, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

<sup>2</sup> Throughout the process of developing and implementing a new regulatory framework for the oversight of derivatives markets, the Commission, in my estimation, has not adequately taken into account the public interest by failing to request comment on issues salient to our ability to carry out our primary regulatory obligations. I have taken exception with the Commission's process in this regard. The resulting public record, in this case, lacks serious consideration of the public interest and has resulted in rules that require little and expect even less.

<sup>3</sup> Certainly, for example, the Commission has the discretion to require large trader reporting in DTF markets. In fact, the U.S. Department of the Treasury requested as much in comments submitted to the Commission on April 9, 2001. Treasury recommended "that there be large trader reporting requirements for any exempt security futures that trade on a DTF as well as on a regulated contract market." Even with such a direct request from a fellow regulator, the Commission has failed to exercise its discretion to insist upon greater transparency.