



A NEW REGULATORY FRAMEWORK

**Report of the
Commodity Futures Trading Commission
Staff Task Force**

February 2000



U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581

William J. Rainer
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February 22, 2000

The Honorable Richard G. Lugar
Chairman
Senate Committee on Agriculture, Nutrition and Forestry
United States Senate
Washington, D.C. 20510

Dear Chairman Lugar:

I am pleased to submit the report of the CFTC Staff Task Force, titled *A New Regulatory Framework*. The staff report presents a comprehensive set of recommended changes to the regulatory structure administered by this agency.

The report responds to your letter of November 30, 1999, encouraging the Commission to use its exemptive authority under Section 4(c) of the Commodity Exchange Act to lessen regulatory burdens on United States futures markets. In the letter, you asked the Commission to provide a status report on our progress in fashioning relief.

The proposed framework described in the report is a flexible structure that replaces the current one-size-fits all style of regulation. While the framework is very much a work in progress, I believe it fairly represents the direction in which the Commission ought to be moving.

The framework establishes three kinds of trading facilities, which would be subject to varying levels of Commission oversight. The degree of oversight applicable to each kind of facility would depend on the nature of the commodities traded on it and the sophistication of the market's participants. The framework also replaces our prescriptive rules with flexible "core principles."

All of the staff recommendations can be implemented by the Commission under its administrative authority. The Commission anticipates using the staff recommendations as the basis for a notice-and-comment rulemaking, to be issued in the near future. During the comment period, we will hold at least one public hearing to provide a full airing of the important public policy issues that the new framework addresses.

The proposed framework promotes innovation, maintains the competitive position of United States markets, reduces systemic risk and provides the necessary level of customer protection. It accomplishes these goals while preserving the public interest in market and price integrity, and protection against market manipulation.

As a separate but related goal, the framework complements the unanimous recommendations of the President's Working Group on Financial Markets.¹ The proposed framework, however, does not obviate the need for Congressional action on the Working Group's recommendations.

On behalf of the entire Commission, I appreciate the opportunity to convey this report to you. We look forward to working with the Congress on this important initiative.

Sincerely,



William J. Rainer
Chairman

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



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February 22, 2000

The Honorable Larry Combest
Chairman
House Committee on Agriculture
United States House of Representatives
Washington, D.C. 20515

Dear Chairman Combest:

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The report responds to your letter of November 30, 1999, encouraging the Commission to use its exemptive authority under Section 4(c) of the Commodity Exchange Act to lessen regulatory burdens on United States futures markets. In the letter, you asked the Commission to provide a status report on our progress in fashioning relief.

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On behalf of the entire Commission, I appreciate the opportunity to convey this report to you. We look forward to working with the Congress on this important initiative.

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A handwritten signature in cursive script, appearing to read "William J. Rainer".

William J. Rainer
Chairman

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A NEW REGULATORY FRAMEWORK

Executive Summary

The Commodity Futures Trading Commission (CFTC or Commission) recently formed a staff task force to recommend changes to the regulatory structure for derivatives. This is the task force's report on its recommendations for modernizing regulation of derivatives. It is not a proposal of the Commission. The report does not include legal definitions for various new categories that it recommends be included in the new framework. Nor does it address comprehensively issues relating to the regulation of commodity pool operators (CPOs) or commodity trading advisors (CTAs). Those issues will be the subject of a further task force study.

By this report, the task force is recommending that the Commission propose a new regulatory framework to apply to multilateral transaction execution facilities that trade derivatives. All of the task force's recommendations can be promulgated by the Commission under its administrative authority. The task force also recommends that the Commission accept its recommendations as the basis for publishing in the Federal Register a notice of proposed rulemaking for a 60-day comment period. The task force further recommends that the Commission hold public hearings on the proposal order to provide a full public airing of the important public policy issues that it raises.

The staff task force believes that this new structure will promote innovation, maintain U.S. competitiveness, reduce systemic risk, and protect derivatives customers. The proposed framework does not require that U.S. futures exchanges change their method of operation in any

way. However, the derivatives markets are poised to undergo rapid change as they continue to embrace technological advances and meet the associated competitive challenges. The new framework provides U.S. futures exchanges the flexibility to respond to these challenges by offering a level of regulation tailored to three alternative types of markets.

Specifically, the staff task force recommends that the Commission propose replacing the current one-size-fits-all regulation for futures markets with broad, flexible “Core Principles.” The Core Principles are tailored to match the degree and manner of regulation to a variety of market structures, to the varying nature of the commodities traded and to the sophistication of customers. Under the recommended framework, U.S. futures markets, in addition to achieving greater flexibility in their current operations as **recognized futures exchanges (RFEs)**, also could choose to operate subject to a lesser degree of regulation for many of the commodities that they trade. For example, they could choose to operate a market exempt from Commission regulation, an **exempt multilateral transaction facility (exempt MTEF)**, for certain commodities. They could also choose to operate a market geared toward sophisticated, institutional traders that is subject to an intermediate degree of regulation and oversight, a **derivatives transaction facility (DTF)**. Or they could operate a combination of the three. The business choice would be theirs.

The following chart summarizes the proposed framework:

**SUMMARY OF REGULATORY FRAMEWORK FOR
MULTILATERAL TRADE EXECUTION FACILITIES**

MARKET	CHARACTERISTICS	REQUIREMENTS
Recognized Futures Exchange (RFE)	<ol style="list-style-type: none"> 1. Any commodity; 2. Any trader 	Fifteen Core Principles
Recognized Derivatives Transaction Facility (DTF) ¹	<ol style="list-style-type: none"> 1. Only commodities with: <ol style="list-style-type: none"> (a) nearly inexhaustible deliverable supplies; (b) no underlying cash market; or (c) individual contracts on a case-by-case basis; or 2. Only commercial traders 	Seven Core Principles
Exempt Multilateral Transaction Facility (Exempt MTEF)	<ol style="list-style-type: none"> 1. Only commodities with: <ol style="list-style-type: none"> (a) nearly inexhaustible deliverable supplies; or (b) no underlying cash market; and 2. Only institutional traders 	<ol style="list-style-type: none"> 1. Anti-fraud section of the CEA; 2. Anti-manipulation section of the CEA; 3. anti-fraud rule; and 4. may not hold self out as regulated

At the same time, the framework provides the over-the-counter (OTC) markets with greater legal certainty regarding market structures or practices that have evolved or that are likely

¹ As noted below, although DTFs are geared toward sophisticated or institutional traders, the framework would permit a facility eligible to be a DTF based upon the nature of the commodities traded to choose to include non-institutional traders.

to evolve in connection with OTC trading. Specifically, the framework includes an exemption for transactions among institutional traders in commodities with inexhaustible deliverable supplies or supplies that are otherwise sufficiently large and deep to render the contract highly unlikely to be susceptible to the threat of manipulation. These markets (exempt MTEFs) would be exempt from all of the requirements of the Commodity Exchange Act (Act or CEA) and Commission rules, except for anti-fraud and anti-manipulation provisions, a requirement that if performing a price discovery function they provide pricing information to the public and a provision that a violation of the terms of the exemption would not render the transactions void. Finally, these exempt markets could not hold themselves out as being regulated by the Commission. As noted above, existing futures markets also have the opportunity to operate under the terms of this exemption, if they so choose. Nothing in the staff proposal, however, would amend or affect the continued vitality of the Commission's exemption for swaps transactions under Part 35 of its rules, or any of its other existing exemptions, policy statements or interpretations.

The framework also provides for an intermediate level of regulation for derivatives markets, known as "Derivatives Transaction Facilities" (DTFs), that are geared toward institutional or commercial traders. A market that is eligible to be exempt from regulation may voluntarily become a DTF in order to become a "recognized" market. Futures exchanges may, if they choose, also operate as a DTF for those commodities with deliverable supplies sufficiently large to render them eligible for the above exemption. Although DTFs are intended primarily for institutional traders, the framework provides the individual DTF the flexibility to decide whether or not to include non-institutional traders. Access to a DTF by non-institutional traders, however, would be permitted only through intermediaries registered with, and regulated

by, the Commission. Those intermediaries would be required to provide their non-institutional customers trading on a DTF with additional price disclosure and other protections. In addition, certain largely commercial markets may operate as DTFs for any commodity. Such commercial traders generally would have both the financial ability and the physical means to deliver tangible commodities.

The staff task force's recommendations also would provide significant regulatory relief for intermediaries. The staff suggests that the Commission streamline its registration procedures, streamline the mandatory risk disclosures provided to non-institutional customers and provide flexibility in how disclosures are made to institutional customers. It also recommends that the Commission propose broadening the range of instruments in which segregated customer funds could be invested, and removing unnecessary operational barriers relating to the secured amount requirements for the funds of customers trading on non-U.S. exchanges. The Commission should also propose relaxing certain registration and associated requirements for account executives who deal only with institutional clients. Finally, the framework clarifies that transactions under the Commission's Part 35 swaps exemption can be cleared, and permits clearing houses or agencies to be separate from an exchange or trading facility.

This new framework changes the structure of derivatives regulation, providing the derivatives markets with the flexibility to decide how they will meet the coming technological and competitive challenges. In doing so, the Commission would retain its oversight authorities to ensure the integrity of the markets and their prices, to deter manipulation, to protect the markets' financial integrity, and to protect customers.

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A NEW REGULATORY FRAMEWORK

I. Background

Since 1989, when the Commission adopted its Swaps Policy Statement, and its subsequent Part 35 swaps exemption in 1993, the over-the-counter (OTC) derivatives markets have experienced dramatic and sustained growth. During this period, OTC financial derivatives have developed into global markets having outstanding contracts with a total notional value of over \$80 trillion. OTC derivatives have transformed finance, increasing the range of financial products available for managing risk.

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

² The PWG, originally established by Executive Order 12631 in March 1988, is composed of the Secretary of the Department of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission and the Chairman of the Commodity Futures Trading Commission.

Although specific recommendations about the regulatory structure applicable to exchange-traded futures were beyond the scope of its report, the PWG suggested that the Commission review existing regulatory structures (particularly those applicable to markets for financial futures) to determine whether they were appropriately tailored to serve valid regulatory goals. Subsequently, by letter dated November 30, 1999, the Chairmen of the Senate and House Agriculture Committees, joined by additional senior Senators and Members of the House of Representatives, “encourag[ed] the Commission to use the exemptive authority granted it by the Commodity Exchange Act to lessen regulatory burdens on United States’ futures markets so that they may compete more effectively.”

A. Staff Task Force

In the meantime, the Commission had formed a staff task force to examine its regulations and to make recommendations on removing unnecessary regulatory burdens. The task force also was asked to make recommendations on moving the Commission from direct to oversight regulation, from prescriptive rules to performance standards, and from merit to disclosure-based regulation.

To ensure that the Commission’s regulations addressed regulatory goals in the least costly and burdensome manner consistent with achieving the Commission’s mission, the task force analyzed the regulatory framework in relation to the four primary objectives of the Act: ensuring market and price integrity; protecting against market manipulation; protecting the financial integrity of the markets; and protecting customers from abusive trading and sales practices. The task force analyzed whether the regulations were commensurate with, and

appropriate to, the particular characteristics of various markets and market participants. These characteristics included the nature of the commodity underlying the contract, the type of trading platform or system used, the use of intermediaries, the use of clearing systems, and the sophistication of the customer. The task force also considered the business structure of the organization sponsoring the trading or clearing facility.

B. Task Force Recommendations

The task force recommends that the Commission replace design-based rules with core regulatory principles that are sufficiently broad to encompass all technologies and business organizations. The task force further recommends that the core principles be supplemented with statements of guidance on practices that comply with the standards, or as appropriate, implementing rules. It also recommends that the Commission's regulatory framework reflect differences in individual markets due to the nature of the commodity traded, the sophistication of market participants and whether the market is intermediated. The task force suggests that the Commission's regulatory framework adhere to internationally-accepted guidance regarding appropriate regulatory measures and that, to the degree possible, it rely on voluntary submission to Commission oversight. Finally, the task force recommends that the Commission's regulatory framework separately address issues relating to the facility on which trades are executed, clearing and intermediation. In making its recommendations, the task force is mindful of the need to reinforce legal certainty regarding those instruments trading over-the-counter pursuant to existing Commission exemptions, interpretations or policy statements, and the recommended framework makes more certain the legality of various OTC transactions.

C. Applying Regulations Appropriate to Various Markets and Participants

The task force is recommending a multifaceted framework for oversight of trading in commodity derivatives contracts on exchanges, facilities or entities. The proposed framework would recognize three broad categories of such facilities: Recognized Futures Exchanges, Derivatives Transaction Facilities and Exempt MTEFs. The level of oversight applied to exchanges or trading facilities would be based on the nature of participants allowed to trade on the facility and the characteristics of the commodities being traded. In general, where access to an exchange or facility is restricted to more sophisticated traders or commercial participants, or where the nature of the commodity being traded poses a relatively low susceptibility to manipulation, regulatory oversight would be set at a lower level, reflecting the reduced need to monitor closely such markets. One constant requirement at all levels of regulation, however, is the need for markets that serve a price discovery function to provide a degree of price transparency. This multifaceted approach to oversight best balances the public interests of market and price integrity, protection against manipulation and customer protection with the need to permit exchanges and other trading facilities to operate more flexibly in today's competitive environment of derivatives trading.

D. Legal Certainty for OTC Markets

The task force recommends that in issuing this exemption, the Commission not make any determination that the exempted transactions are or are not subject to its jurisdiction. When it adopted Section 4(c) in 1992, the Conferees of the Congress stated:

The Conferees do not intend that the exercise of exemptive authority by the Commission [under Section 4(c)] would require any determination beforehand that the agreement, instrument, or transaction for which an exemption is sought is subject to the Act. Rather, this provision provides flexibility for the Commission to provide legal certainty to novel instruments where the determination as to jurisdiction is not straightforward.³

In exercising this exemptive authority to date, the Commission has not made a determination that the transactions being exempted were or were not subject to the Commission's jurisdiction under the CEA.⁴ Moreover, neither the Congress nor the CFTC ever has made a definitive judgment that the swap agreements exempted by the Commission under Section 4(c) are, in fact, subject to the CEA's jurisdiction.⁵

Accordingly, the Commission would not make a determination that any market that is eligible to be an exempt MTEF is or is not subject to the Commission's jurisdiction under the CEA. Moreover, the fact that one market may rely upon the exemption for exempt MTEFs, or that such an exempt MTEF voluntarily submits to CFTC oversight as a recognized DTF or RFE,

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

⁴ For instance, when the Commission exempted certain swap agreements in 1993, pursuant to Section 4(c) of the Act, it stated:

The issuance of this rule [Rule 32.5] should not be construed as reflecting any determination that the swap agreements covered by the terms hereof are subject to the Act, as the Commission has not made and is not obligated to make any such determination.

58 Fed. Reg. 5587, 5588 (Jan. 22, 1993). See also Order Granting the London Clearing House's Petition for an Exemption Pursuant to Section 4(c) of the Commodity Exchange Act, 64 Fed. Reg. 53346 (October 1, 1999); Exemption for Certain Contracts Involving Energy Products, 58 Fed. Reg. 21286, 21288 (Apr. 20, 1993); Regulation of Hybrid Instruments, 58 Fed. Reg. 5580, 55821 n. 2 (Jan. 22, 1993).

⁵ Testimony of William J. Rainer, Chairman, Commodity Futures Trading Commission, before the Committee on Agriculture, U.S. Senate, "Hearing on the Report by the President's Working Group on Financial Markets: 'Over the Counter Derivatives Markets and the Commodity Exchange Act,'" February 10, 2000.

does not imply that the Commission has made a determination that that market, or any other firm or entity that operates in a similar manner, is subject to the Commission's jurisdiction under the CEA. However, a market that has chosen to become recognized by the Commission as a DTF or RFE is bound by the Act and Commission rules, as applicable.

II. Recommended Regulatory Framework

A. Swaps

Although the Part 35 swaps exemption is not part of the new regulatory framework, it is relevant to the new exemptions included in the framework. The swaps exemption itself under Part 35 is not changed in any way. It remains in effect as promulgated, reinforcing the certainty that transactions undertaken in reliance upon the exemption are assured that the exemption itself will remain in force as originally adopted. Moreover, the CFTC's 1989 Swaps Policy Statement, its energy interpretation and the CFTC energy exemption are unchanged.

Even though there are no changes to the Part 35 swaps exemption, legal certainty for such instruments would be enhanced under the framework. First, as discussed below, the framework would clarify in a separate rule that Part 35 swap agreements can be cleared. Secondly, the Commission would provide in a separate provision that transactions entered into in reliance on the Part 35 swaps exemption would not be void as a matter of law due to a violation of the exemption's requirements. Finally, a new exemption included in the framework that is discussed below provides additional legal certainty that certain trading structures or clearing practices that have evolved, or may evolve, in the over-the-counter markets are exempt from the Act and the

Commission's rules. Finally, the staff recommends that the Commission consider whether legal certainty for swap transactions would be further enhanced by republishing the Swaps Policy Statement, which would not be changed in any way, as an Appendix to Part 35 of the Code of Federal Regulations. This would indicate the Commission's continuing recognition of the Policy Statement's vitality and would assist the public in locating it.⁶

B. Exempt Multilateral Transaction Execution Facilities (Exempt MTEFs)

The framework provides a new, self-effectuating exemption for those multilateral transaction facilities specified in the rule. Under the proposed framework, an exemption would be provided for transactions among institutional traders in commodities with inexhaustible deliverable supplies or supplies that are otherwise sufficiently large and deep to render a contract traded on them highly unlikely to be susceptible to the threat of manipulation. These markets would be exempt from all of the requirements of the Act and Commission rules except for anti-fraud and anti-manipulation provisions, a requirement that if serving a price discovery function they provide pricing information to the public and a provision that a violation of the terms of the exemption would not render the transactions void. These markets also could not hold themselves out as being regulated by the Commission.

The relatively few requirements that would be placed on these facilities follow from the reduced threat of manipulation of the contracts traded on an exempt MTEF, and the ability of institutional market participants to monitor their activity and assess the risks involved in trading

⁶ The Swaps Policy Statement is found at 54 FR 30694 (July 21, 1989).

in these markets. Traditionally, the Commission has relied on, or required exchanges to use, a variety of methods to ascertain and address the problem of manipulation of commodity contracts. These include approval of the terms of the contract, monitoring position sizes, imposing position limits, and active market surveillance. These regulatory protections are unnecessary where, by definition, it would be virtually impossible to manipulate the underlying commodity's price. Similarly, the framework relies on the institutional participant's greater ability to understand the risks involved in trading in a less-regulated environment, obviating the need for customer protection requirements.

Multilateral trade execution facilities are eligible for this exemption if they:

1. restrict access to institutional customers or participants; and
2. trade contracts based only on commodities that have a nearly inexhaustible deliverable supply, that have a deliverable supply sufficiently large and a cash market sufficiently liquid to render the contract, whether physically delivered or cash settled, highly unlikely to be susceptible to the threat of manipulation or that have no underlying cash market.

MTEFS that meet these eligibility requirements are automatically exempt from all provisions of the Act except for the anti-fraud provisions of sections 4b and 4o of the Act and the anti-manipulation provisions of sections 6(c) and 9(a)(2) of the Act. They also are exempt from all Commission regulations except for the following:

1. an anti-fraud provision within the exemption itself;
2. a requirement that if the facility serves as a significant source of price discovery for the underlying commodity, it must publicly disseminate, on a daily basis, trading volume and price ranges and other trading data as appropriate to the market; and

3. a provision that transactions consummated in reliance upon the exemption are not void as a matter of law owing to a violation of the exemption's provisions.

An exempt MTEF must be operated by an entity that is legally separate from an entity that is the operator of a designated contract market, a recognized futures exchange or a recognized derivatives transaction facility and, depending on the trading mechanism, it must clearly identify trading products by market on its electronic system or provide for a separate physical trading location for its products.

C. Derivatives Transaction Facilities (DTFs)

Under the new regulatory framework, a board of trade, facility, or entity, regardless of the means of communicating bids and offers or the matching system used, would be eligible to become a "recognized derivatives transaction facility" if the contracts traded on the facility are for underlying commodities that have an inexhaustible deliverable supply, deliverable supplies that are otherwise sufficiently large and deep to render the contract highly unlikely to be susceptible to the threat of manipulation or commodities having no underlying cash market. To be recognized as a DTF, an exchange, facility, or entity must already have been designated under section 6 of the Act as a contract market or must obtain CFTC approval.⁷ The Commission also expects, however, on a case-by-case basis, that it may find that the surveillance history and the self-regulatory undertakings of a particular exchange or facility may make it possible to include a specific contract traded on that facility within the DTF category even if the underlying

⁷ The staff also recommends that the Commission consider providing for an additional fast track method for recognition through certification by the DTF to the CFTC that it meets the conditions for recognition.

commodity does not meet the general eligibility criterion. An exchange or facility seeking a case-by-case determination may be recognized as a DTF only upon CFTC approval.

A facility eligible to be a DTF on the basis of the commodities traded would have the choice of whether or not to permit access to the market by non-institutional traders. Non-institutional traders could have access to a DTF only if their trades were intermediated by a CFTC registrant that is a member of a futures industry self-regulatory organization. Moreover, as discussed below, those firms and their associated persons must provide their non-institutional customers with enhanced disclosure, must offer additional protections, and must meet a number of additional requirements. The DTF, if it chooses, however, may limit access to only institutional participants.⁸

In addition, a board of trade, facility, or entity, regardless of the means of communicating bids and offers or the matching system used, would be eligible to become a "recognized derivatives transaction facility" if the facility restricts participation to qualifying commercial participants, regardless of the underlying commodity. Many of these trading facilities are expected to replicate electronically various aspects of today's commercial markets, including trading exclusively between principals, direct negotiation and documentation of trades, and the absence of clearing arrangements. Although the derivative contracts listed for trading may be based on tangible commodities, this type of market structure ameliorates many of the regulatory

⁸ Some markets that meet both the commodity eligibility requirement and permit access only to institutional traders and are thereby eligible to be exempt MTEFs may choose to seek recognition as a DTF. By choosing to comply with the additional DTF requirements outlined in this framework and thereby becoming recognized, the facility would be acknowledged to have met a higher regulatory standard.

concerns regarding susceptibility to manipulation ordinarily present with contracts for tangible commodities.

Although this basis for eligibility as a DTF applies to all commodities, the staff notes that the domestic agricultural commodities listed in section 1a(3) of the Act⁹ may constitute a unique category. The current futures markets tend to be the primary, if not the only, centralized source of price discovery and price basing for certain agricultural commodities. The utility and efficiency of the centralized futures markets in price discovery for these commodities is unquestioned. For this reason, the Commission has at times not included the agricultural commodities in certain regulatory programs. For example, options on agricultural futures contracts were introduced subsequent to options trading on non-agricultural commodities and the enumerated agricultural commodities are not included in the existing Part 36 exemption. On the other hand, members of the agricultural community have at times argued that they should not be prohibited from benefiting from innovative trading products that are available for non-agricultural commodities. In light of the unique considerations that these commodities present, the staff recommends that the Commission specifically seek comment from the agricultural community on the advisability of including the agricultural commodities listed in the Act in this category at this time.

To be recognized as a derivatives transaction facility, the facility must provide for:

⁹ They are wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, potatoes, wool, wool tops, fats and oils, cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice.

1. Rules relating to trading on its facility, including, depending on the nature of the trading mechanism:
 - a. rules to deter trading abuses, and adequate power and capacity to detect, investigate and take action against violation of its trade rules including arrangements to obtain necessary information to perform the above functions, or
 - b. use of technology that provides participants with impartial access to transactions and captures information that is available for use in determining whether violations of its rules have occurred;
2. Rules or terms and conditions defining, or specifications detailing, the operation of the trading mechanism or electronic matching platform; and
3. Rules or terms and conditions detailing the financial framework applying to the transactions or ensuring the financial integrity of transactions entered into by, or through, its facilities.

A recognized derivatives transaction facility initially, and on a continuing basis, must meet and adhere to the following seven core principles.

CORE PRINCIPLES FOR RECOGNITION OF DERIVATIVES TRANSACTION FACILITIES

1. **Enforcement. Monitor and enforce its rules or terms and conditions including, if applicable, limitations on access.**
2. **Market oversight. As appropriate to the market and the contracts traded: a) monitor markets on a routine and nonroutine basis as necessary to ensure orderly trading and have and where appropriate exercise authority to maintain an orderly market; or b) provide information to the CFTC as necessary for the CFTC to satisfy its obligations under the CEA.**
3. **Operational information. Disclose to regulators and market participants, to the extent possible, information concerning trading terms, contract terms and conditions, trading mechanisms, financial integrity arrangements or mechanisms, as well as other relevant information.**
4. **Transparency. Provide to market participants on a fair, equitable and timely basis information regarding prices, bids and offers, and other**

information appropriate to the market and, as appropriate to the market, make available to the public with respect to actively traded products and, to the extent applicable, information regarding daily opening and closing prices, price range, trading volume and other related market information.

5. **Fitness.** As appropriate to the market, have fitness standards for members, operators or owners with greater than 10 percent interest or an affiliate of such an owner, members of the governing board, and those who make disciplinary determinations.
6. **Recordkeeping.** Must keep full books and records of all activities related to its business as a recognized derivatives transaction facility, including full information relating to data entry and trade details, in a form and manner acceptable to the CFTC for a period of five years, during the first two of which the books and records are readily available, and which shall be open to inspection by any representative of the CFTC or the U.S. Department of Justice.
7. **Competition.** Recognized derivatives transaction facilities should avoid unreasonable restraints of trade or imposing any burden on competition not necessary or appropriate in furtherance of the objectives of the Act or the regulations thereunder.

The following additional requirements would apply to recognized derivatives transaction facilities:

1. an anti-fraud provision within the rule itself;
2. a provision that transactions consummated in reliance upon this exemptive rule are not void as a matter of law due to a violation of the exemptive rule; and
3. a provision requiring that a recognized derivatives transaction facility that also maintains a designated contract market or a recognized futures exchange, depending upon the trading mechanism, clearly identify trading products by market on its electronic system or provide for separate physical trading locations.

D. Recognized Futures Exchanges (RFEs)

Recognized futures exchanges would include multilateral transaction execution facilities which permit access to any type of customer, including both institutional and non-institutional

customers or participants and that trade contracts including those that are based on commodities that have finite deliverable supplies or cash markets with limited liquidity. Examples of such markets would generally include the current futures markets trading contracts on physical commodities. Because these markets potentially have a greater susceptibility to price manipulation and raise greater concerns regarding customer protection, they would be subject to a higher level of Commission oversight. Thus, the proposed framework retains greater market surveillance and position reporting obligations for these markets.

Nevertheless, the framework also provides meaningful regulatory relief to recognized futures exchanges from the current requirements applicable to designated contract markets. First and foremost, the framework provides recognized futures exchanges with greater operational flexibility by using broad Core Principles. For example, the Core Principles will replace technical rules relating to audit trail and conflict of interest procedures with more flexible standards. In addition, the framework removes the requirement that the Commission pre-approve new contracts and rule amendments. Moreover, enforcement responsibility for sales practice abuses would rest with the intermediaries' self-regulatory organization, rather than with the exchanges. Finally, the framework retains the Commission's authority to make determinations on the acceptability of exchange rules or practices in light of the interests of anti-trust policies and the goals of the Act.

Any board of trade, facility or entity, regardless of the means of communicating bids and offers or the matching system used, that is otherwise required to be designated under section 6 of the Act as a contract market, is eligible to be a recognized futures exchange. Any eligible board of trade, facility or entity that is not already designated under Section 6 of the Act as a contract

market must apply for recognition as a futures exchange and meet the conditions for recognition under these rules.

To be recognized as a futures exchange, a board of trade, facility, or entity, regardless of the means of communicating bids and offers or the matching system used, must demonstrate initially that it has:

1. A clear framework for conducting programs of market surveillance, compliance, and enforcement, including having procedures in place to make use of collected data for real-time monitoring and for post-event audit and compliance purposes to prevent market manipulation.
2. Rules relating to trading on its facility, including rules to deter trading abuses, and adequate power and capacity to detect, investigate and take action against violations of its trading rules, and a dedicated regulatory department or delegation of that function to an appropriate entity.
3. Rules defining, or specifications detailing, the manner of operation of the trading mechanism or electronic matching platform and a trading mechanism or electronic matching platform that performs as defined in the operational rules or specifications.
4. A clear framework for ensuring the financial integrity of transactions entered into by or through its facility.
5. Established procedures for impartial disciplinary committee(s) or other similar mechanisms empowered to discipline, suspend, and expel members, or to deny access to participants or, if provided for, discipline participants.
6. Arrangements to obtain necessary information to perform the above functions, including the capacity and arrangements to carry out the International Information Sharing Agreement and Memorandum of Understanding developed by the Futures Industry Association (FIA) Global Task Force on Financial Integrity. A mechanism to provide to the public ready access to its rules and regulations.

A recognized futures exchange initially and on a continuing basis, must meet and adhere to the following 15 core principles:

**CORE PRINCIPLES FOR RECOGNITION
OF FUTURES EXCHANGES**

1. **Rule enforcement.** Monitor and enforce its rules.
2. **Products.** List contracts for trading which are not readily susceptible to manipulation.
3. **Position monitoring and reporting.** Monitor markets on a routine and nonroutine basis as necessary to prevent manipulation, price distortion, and disruptions of the delivery or cash settlement process.
4. **Position limits.** Adopt position limits on trading where necessary and appropriate to lessen the threat of market manipulation or congestion during delivery months.
5. **Emergency authority.** Exercise authority to intervene to maintain an orderly market, including where applicable authority to liquidate or transfer open positions, to require the suspension or curtailment of trading, and to require the posting of additional margin.
6. **Public information.** Make information concerning the contract terms and conditions and the trading mechanism, as well as other relevant information, readily available to market authorities, users and the public.
7. **Transparency.** Provide, appropriate to the market, information to the public regarding prices, bids and offers, including the opening and closing prices and daily range, and information on volume and open interest.
8. **Trading system.** Have the appearance of providing, and provide, a competitive, open, and efficient market.
9. **Audit trail.** Have in place procedures to ensure the recording of full data entry and trade details, the safe storage of such information and systems to enable information to be used in assisting in combating customer and market abuse. Such procedures should ensure the quality of data captured.
10. **Financial standards.** Have, monitor, and enforce rules regarding the financial integrity of the transactions that have been executed on the facility and, where intermediaries are permitted, have rules addressing the financial integrity of the intermediary and the protection of customer funds as appropriate and a program to enforce those requirements.

11. **Customer protection.** Have, monitor and enforce rules for customer protection.
12. **Dispute resolution.** Provide for alternative dispute resolution mechanisms appropriate to the nature of the market.
13. **Governance.** Have fitness standards for members, for owners or operators with greater than 10 percent interest or an affiliate of such an owner, members of the governing board, and those who make disciplinary determinations. The recognized futures exchange must have a means to address conflicts of interest in making decisions. For mutually owned futures exchanges, the composition of the governing board must reflect market participants.
14. **Recordkeeping.** Must keep full books and records of all activities related to their business as a recognized futures exchange in a form and manner acceptable to the CFTC for a period of five years, during the first two of which the books and records are readily available, and which shall be open to inspection by any representative of the CFTC or the U.S. Department of Justice.
15. **Competition.** Recognized futures exchanges should avoid unreasonable restraints of trade or impose any burden on competition not necessary or appropriate in furtherance of the objectives of the Act or the regulations thereunder.

E. Intermediaries

The framework provides greater flexibility for intermediaries and their customers by making use of Core Principles and statements of Best Practices, and by distinguishing the requirements that apply to institutional and non-institutional customers. The greater flexibility that this permits is particularly evidenced by the differing disclosures that are required to be provided to these two types of customer. The framework also provides some flexibility with respect to aspects of an intermediary's financial requirements. Greater flexibility with regard to the financial requirements for intermediaries trading on a DTF would be available in the

discretion of such a market. In addition, the framework provides for streamlining the registration application process for futures commission merchants (FCMs) and introducing brokers (IBs).

Intermediaries in all CFTC recognized markets, absent an exemption, are required to be registered with the CFTC.¹⁰ The framework provides that the registration application process for FCMs and IBs would be streamlined. Intermediaries on a recognized futures exchange must be registered with the Commission in the appropriate registration category and must belong to a futures self-regulatory organization. Intermediaries trading on a DTF must also be registered with the Commission. However, intermediaries trading on a DTF that are registered and in good standing with the Securities and Exchange Commission (SEC) or that are overseen by and in good standing with a Federal banking regulator, may rely upon that registration or authorization as proof of compliance with CFTC registration requirements. The Commission will work with the SEC, the banking regulators and non-futures industry self-regulatory organizations on a means of cooperating with the primary regulator in the oversight of these entities' DTF-related activities.

As noted above, DTFs may determine to permit access by non-institutional traders. Non-institutional traders may trade on a DTF only through a registered FCM that meets the additional requirements of being a clearing member of at least one Recognized Futures

¹⁰ Intermediation on an exempt MTEF is not subject to separate regulation by the Commission. Intermediaries must only themselves be eligible to trade on an exempt MTEF and are subject to the anti-fraud and anti-manipulation provisions.

Exchange and having minimum net capital of at least \$20 million. Moreover, the National Futures Association will issue a Statement of Best Practices for markets and intermediaries regarding additional disclosures to be made to non-institutional customers trading on DTFs and on related issues involving price dissemination.

An applicant for registration as an associated person (AP) must demonstrate, among other things, his or her proficiency to a futures SRO through a test. The framework would require competency tests and ethics training only for APs with non-institutional customers, and their direct supervisors. APs handling only institutional clients would be subject to the proficiency requirements of their employer. In addition, the Act requires all individual registrants in the industry to take periodic ethics training. The framework would permit employers to decide on the ethics training that their employees should receive. A Statement of Best Practices on training would be issued.

The disclosure of risks to customers by intermediaries is an important customer protection. However, over the years, many have suggested that customers would be better protected by receiving risk disclosures more attuned to their relative level of sophistication. In keeping with that observation, the framework provides that non-institutional customers continue to receive the mandatory risk disclosures regarding futures and option trading that are currently required. These mandatory disclosures would be somewhat streamlined and would make use of a single signature format, which could include an electronic signature, rather than the multiple signatures that are currently required. In contrast, institutional customers would be covered by a general requirement that the disclosure be appropriate to the customer and the market on which

the customer is trading. The Commission would, with industry input, issue a statement of Best Practices on disclosure to institutional clients.

The futures industry has a long history of keeping customer funds safe. Initiatives to reform the Commission's regulation of intermediaries involving various financial safeguards have been made with this successful history in mind. Segregation of customer funds has worked well and should continue to be the rule for all customers trading on an RFE and all non-institutional customers trading on a DTF. Nevertheless, the task force recommends a number of initiatives related to segregation of customer funds. First, the Commission should expand the instruments acceptable for investment of segregated funds. In addition to those instruments included in section 4d of the Act, the Commission by rule should permit customer segregated funds to be invested in any comparably highly liquid and readily marketable instrument that is acceptable as collateral by the clearing organization with which the intermediary deals. Secondly, the Commission should examine ways to remove unnecessary operational barriers between the segregation of customer funds requirement on U.S. exchanges with the secured amount requirements pertaining to the funds of customers trading on non-U.S. exchanges. Finally, the task force recommends that the Commission consider whether institutional customers should be able to direct their intermediaries not to segregate their funds when trading on a DTF that so permits. However, the intermediary would be required to disclose to the customer the treatment of such funds in the event of a bankruptcy.

Under the framework, intermediaries must meet the net capital requirements of the CFTC, SEC, or banking regulator. The minimum net capital requirement should be updated and made more flexible, however, by promulgating rules to permit the application of risk-based net

capital requirements. Moreover, intermediaries trading for institutional customers on a DTF would not be required to comply with the Commission's net capital requirement if they were subject to alternative regulatory oversight of their financial condition.

The Core Principles that apply to intermediaries follow:

CORE REQUIREMENTS FOR INTERMEDIARIES

- 1. Registration required. Any person or entity intermediating a transaction on a recognized futures exchange, or on a recognized derivatives transaction facility that permits intermediation of trading must be registered in the appropriate capacity or deemed to be registered by the Commission as a futures commission merchant, introducing broker, commodity trading advisor, commodity pool operator, an associated person of any of the foregoing, floor trader or floor broker.**
- 2. Fitness of registrants. Intermediaries in all multilateral transaction execution facility markets recognized by the CFTC must be and remain fit.**
- 3. Financial. Intermediaries must keep and safeguard customer money and have sufficient capital to ensure their capacity to meet their obligations to customers.**
- 4. Risk Disclosure. Intermediaries must provide to customers risk disclosure appropriate to the particular instrument and the customer.**
- 5. Trading Standards. Intermediaries and their affiliated persons are prohibited from misusing knowledge of their customers' orders.**
- 6. Supervision. All intermediaries including associated persons having supervisory responsibilities must diligently supervise all commodity futures and commodity options accounts carried, operated, advised, introduced, handled or traded by the intermediary as well as all of its other activities arising in its business as an intermediary. All intermediaries must establish and maintain supervisory procedures.**
- 7. Reporting of positions. Report to the Commission, futures exchange or derivatives transaction facility information that permits the futures exchange or derivatives transaction facility to identify concentrations of positions and market composition on a routine and nonroutine**

basis as required by the futures exchange or derivatives transaction facility.

- 8. Recordkeeping. Must keep full books and records of all activities related to their business as a futures commission merchant, introducing broker, floor broker, floor trader, commodity trading advisor or commodity pool operator, in a form and manner acceptable to the CFTC for a period of five years. Such information must be readily available during the first two years and be produced to the CFTC at the expense of the person required to keep the books or records. All such books and records shall be open to inspection by any representative of the CFTC or the U.S. Department of Justice.**

F. Clearing

The framework also provides for competition and flexibility in the provision of clearing services. It provides that a clearinghouse or clearing agency could be independent of an execution facility. The framework requires that clearinghouses or agencies that clear transactions executed on an RFE or DTF be authorized by the Commission. All current futures clearinghouses would be so authorized. Moreover, the task force recommends that the Commission explore mechanisms by which clearinghouses or agencies authorized by the Securities and Exchange Commission, the Federal banking regulators or an approved foreign regulatory authority could also be authorized by the Commission to clear transactions on DTFs, giving deference to the other agency's oversight responsibilities. The Commission should also explore harmonizing requirements for authorization with the other regulators.

Clearing for transactions exempt under Part 35 or for exempt MTEFs should be subject to CFTC oversight or oversight by the SEC, a Federal banking regulator or an approved foreign regulatory authority. The framework provides that the Commission recognize clearing organizations that, initially and on a continuing basis, meet the following Core Principles.

CORE PRINCIPLES FOR RECOGNITION OF CLEARING ORGANIZATIONS

- A. Financial Resources. Demonstrates that it has adequate capital resources to fulfill its guarantee function without interruption in various market conditions.**
- B. Participant and Product Eligibility Has established appropriate admission and continuing eligibility standards for members or participants of the organization including appropriate minimum financial requirements. Those requirements can be expressed, for example, in terms of capital, net worth, net income, liquidity, and/or other measures. Defines criteria of instruments that will be accepted for clearing and the clearing function to be performed for each type of instrument.**
- C. Risk Management. Demonstrates an ability to manage the risks associated with carrying out its guarantee function through the use of appropriate tools and procedures such as:**
- 1. Risk Analysis. Testing the adequacy of the overall level of financial resources and specific risk management tools including collateral and credit limits, on an appropriate periodic basis in a variety of market conditions through stress testing and value at risk calculations.**
 - 2. Use of Collateral. Establishing and collecting appropriate forms and levels of collateral.**

Amounts should be adequate to secure prudentially obligations arising from clearing transactions and performing as central counterparty. Measures should be employed to ensure appropriate valuation of open positions and collateral assets. An appropriate margin collection schedule should be followed to address changes in market positions and collateral values. Criteria should be established for appropriate types and forms of collateral.
 - 3. Credit Limits. Implementing systems that prevent members and other market participants from exceeding appropriate credit limits.**
 - 4. Margin Reduction Programs. Holding collateral assets supporting cross-margining programs pursuant to legal frameworks providing for clear, fair, and efficient loss-sharing arrangements in the event of a program participant default.**
- D. Settlement Procedures. Demonstrates that it can complete settlements on a timely basis under varying circumstances, maintain an adequate record of the flow of funds associated with each transaction it clears, and comply with**

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

- E. **Treatment of Client Funds.** Has standards and procedures designed to protect and insure the safety of client funds such as:
1. **Safe Custody.** Depositing client funds in accounts in depositories or with custodians that meet industry standards of safety pursuant to written terms that address the legal status of the funds and specific conditions or prerequisites for movement of the funds and in such number to ensure adequate diversification of concentration of risk.
 2. **Segregation.** Segregating, and requiring members or participants that clear trades executed on behalf of customers to segregate, customer accounts and funds and not commingle customer with proprietary funds, or obligate customer funds for any purpose other than to purchase, clear, and settle the products the clearing organization is clearing.
 3. **Investment Standards.** Investing customer funds only in securities or obligations that meet high standards of safety and keeping adequate records regarding all details of such investments.
- F. **Default Rules and Procedures.** Has in place rules and procedures designed to allow for efficient, fair, and safe management of events when members or participants become insolvent or otherwise default on their obligations to the clearing organization, such as:
1. **Definition of Default.** Establishing and enforcing a clear definition of default. This should address failure to meet margin requirements and the insolvent financial condition of a member or participant, and also could include failure to comply with certain rules, maintain eligibility standards, certain action taken by other regulatory bodies, and other events, as defined by the clearing organization.
 2. **Remedial Action.** Establishing the authority of the clearing organization to take appropriate action in the event of the default of a member or participant which could include, among other things, closing out positions, replacing positions, set off, and margin application.
 3. **Process to Address Shortfalls.** Establishing procedures for the prompt, fair, and safe application of clearing organization and/or member financial resources to eliminate any monetary shortfall resulting from a default.
 4. **Customer Priority Rules.** Applying rules regarding priority of:

- a. **Customer accounts over the proprietary accounts of intermediary members or participants; and**
 - b. **Where appropriate, accounts of customers that do not participate in specialized margin reduction programs (such as cross margining) or trading links with other exchanges over accounts of customers that do participate in such programs.**
- G. **Rule Enforcement. Demonstrates that it has established and can maintain adequate arrangements and resources for the effective monitoring and enforcement of compliance with its rules and for resolution of disputes. Toward that end, have the authority and ability to discipline, limit, suspend, or terminate a member's or participant's activities pursuant to clear and fair standards.**
- H. **System Safeguards. Demonstrates that it will maintain a program of oversight and risk analysis to ensure that its automated systems function properly and have adequate capacity and security.¹¹ It should establish and maintain emergency procedures and a plan for disaster recovery and periodically test back-up facilities sufficient to ensure daily processing, clearing, and settlement of transactions.**
- I. **Reporting. Provides to the Commission all information necessary for the Commission to conduct its oversight function as to the clearing organization's activities. For example, information which relates to counterparties and their positions, stress tests, internal governance, legal proceedings, and other clearing activities.**
- J. **Recordkeeping. Keeps full books and records of all activities related to its business as a recognized clearing organization in a form and manner acceptable to the CFTC for a period of five years. Such information must be readily available during the first two years and be produced to the CFTC at the expense of the person required to keep the books or records. All such books and records shall be open to inspection by any representative of the CFTC or the U.S. Department of Justice.**
- K. **Public Information. Makes information concerning the rules and operating procedures governing the clearing and settlement systems, including default procedures, available to market participants.**
- L. **Information Sharing. Enters into and abides by the terms of all appropriate and applicable domestic and international information-sharing agreements**

¹¹ Such a program should address the areas specified by the International Organization of Securities Commissions' Principles for the Oversight of Screen-Based Trading Systems for System Security and Vulnerability and would include periodic external or internal review and testing of the trading system.

and uses relevant information obtained from such agreements in carrying out the clearing organization's risk management program.

- M. **Competition.** Avoids unreasonable restraints of trade or imposes any burden on competition not necessary or appropriate in furtherance of the objectives of the Act or the regulations thereunder. A recognized clearing agency may request the Commission to issue an order considering whether a rule or practice is the least anticompetitive means of achieving the objective, purposes and policies of the Act, and may request that the Commission approve rules under section 5a(a)(12) of the Act and Commission rules thereunder.

- N. **Fraud and Manipulation.** Is subject to the anti-fraud and anti-manipulation provisions of the Act.